GREENFIELD FOREIGN DIRECT INVESTMENTS IN SERBIA

Center for Liberal-Democratic Studies

Boris Begović, Boško Mijatović, Marko Paunović and Danica Popović
Greenfield Foreign Direct Investments in Serbia

Published by:
Center for Liberal-Democratic Studies, 2008

Printed in Serbia by:
Akademija, Belgrade

ISBN 978-86-83557-47-9

CIP – Katalogizacija u publikaciji
Narodna biblioteka Srbije, Beograd

339.727./.24 (497.11)
351.712 : 69 (497.11)

GREENFIELD Foreign Investments in Serbia / Boris Begović … [et al.]. – Belgrade : Center for Liberal-Democratic Studies, 2008 (Belgrade : Akademija). – 109 str. : graf. prikazi, tabele ; 24 cm.

Tiraž 500. – Glossary: str. 99–105. – Napomene i bibliografske reference uz tekst. – Bibliografija: str. 107–109.

ISBN 978-86-83557-47-9

1. Begović Boris [autor]
a) Inostrane investicije – Srbija
b) Investicioni objekti – Srbija – 2001-2006

COBISS.SR-ID 149749772

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Supported by a grant from ***Vip mobile d.o.o.***
The opinions expressed in this book are those of the authors and do not necessarily reflect the views of ***Vip mobile d.o.o.***

Foreword

There is little doubt that Greenfield foreign direct investments (FDIs) are one of the major engines of economic growth in many countries in the world, particularly emerging markets. The idea behind this book is to explore four main issues regarding Greenfield FDIs. First, to explore basic facts and figures, and to provide some basic information on Greenfield FDIs overall, as well as regional and in Serbia. Second, to explore direct effects of Greenfield FDIs on economic and productivity growth. Third, to explore indirect (spillover) effects of Greenfield FDIs on economic and productivity growth. Finally, to explore preconditions for Greenfield FDIs in terms of public policies and institutions of the recipient country. We are grateful to *Vip mobile d.o.o.* who has encouraged and supported this research. Needless to say, the opinions expressed in this book are those of the authors and do not necessarily reflect the views of *Vip mobile d.o.o.*

Belgrade, June 10th, 2008

Boris Begović
Boško Mijatović
Marko Paunović
Danica Popović

Contents

Chapter I

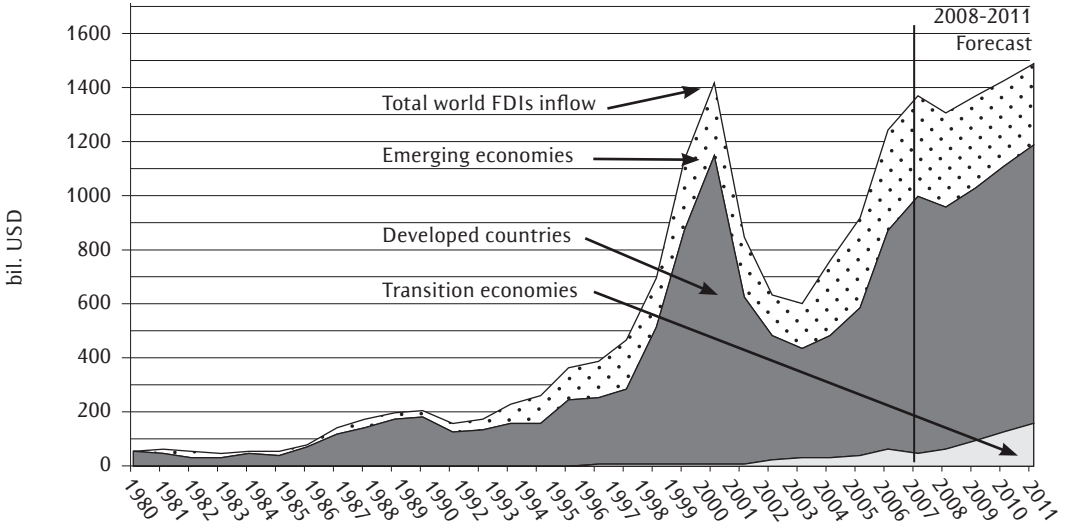
FDIs and Greenfield FDIs: some basic facts and figures

1. Evolution of FDI flows in the world

After four consecutive years of rapid growth, FDIs in 2007 grew 10% and reached the 2001 record of USD1.4 trillion. The immense fall in FDIs can primarily attributed to the recession in the US economy, which almost halved FDI inflows into developed countries and emerging economies of developing Asia and Latin America. Transition economies skipped the fall and recorded growth of 56% in 2006, reaching 5% of total FDI inflows in 2007.

United States recovered its position of the largest single host country for FDI in the world, with 17% of total FDI inflows. European Union (EU 25) accounted for 45% of total FDI inflows in 2006, while Japan recorded negative net inflows for the first time since 1989. China and Hong Kong (with 6% and 3.2% of total world FDI inflows, respectively) remain the leading destinations in Developing Asia. India also saw record inflows as well, but with 1.6% of total FDI inflows, remains to seriously lag behind previous two Asian competitors. New EU members – Hungary, Poland and

Figure 1 Foreign direct investments by region, 1980–2011



Source: UNCTAD Investment Brief, November 2007 and EIU, 2007.

Table 1 Growth of FDI inflows, 2001-2011

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
% change, year on year	-41	-25	-8.8	29.6	33.1	37.4	10.5	-4.6	4.5	4.5	4.4

Source: EIU, 2007.

Table 2 Greenfield (new) FDI projects in the world, top recipient countries 2005-2006

	2005 Number of projects	Share in world total (%)	2006 Number of projects	Share in world total (%)	% change, year on year
China	1,237	11.84	1,378	11.66	11.4
India	590	5.65	979	8.29	65.9
US	563	5.39	725	6.14	28.8
UK	633	6.06	668	5.65	5.5
France	489	4.68	582	4.93	19.0
Russia	511	4.89	386	3.27	-24.5
Romania	261	2.50	362	3.06	38.7
Germany	271	2.59	333	2.82	22.9
Poland	271	2.59	324	2.74	19.6
Bulgaria	140	1.34	286	2.42	104.3

Source: LOCOmonitor Monthly Investment Monitor Global (MIM) edition, 2007.

Czech Republic keep continuously attracting USD 22-28 billion of FDIs, interchanging positions amongst each other (tables with details on FDI flows are in the Tables A1-A6 to this chapter).

Although this was the fourth consecutive year of impressive growth of FDI flows— reaching over 30% annual growth in nominal US dollars, a caveat remains in weakening of US dollar, which had dramatically boosted the nominal US dollar-denominated totals. But despite the recovery in 2004-07, when measured as a percentage of the world's GDP, FDI inflows remain below 3% of world GDP in 2007, still considerably lower than their peak of 4% share in GDP at the end of the previous decade.

After a long period of slow growth, FDIs structure by sector started to evolve since 2001, when primary sector FDIs started to grow from 2% in 2001 to 18% in 2006. These developments are primarily triggered by strong growth of Chinese economy and obviously sustainable rising demand for oil and gas in the medium term. But services remain the main destination of the FDIs in the world, although their share diminished from 74% to 54% of total investments. Financial services, telecommunications and real estate recorded highest and undisturbed growth throughout the whole period. When analyzed by industries, top ten industries comprised software & IT services (11% of all FDI projects), financial services (7.5%), food & tobacco (5.7%), business services (5.34%), communications (4.21%), etc.[1]

It is only when measured by the number of Greenfield investments that most dynamic economies of the world – China and India – come to the top of the list. Four transition economies, including Russia, Romania, Poland and Bulgaria, are also listed in top ten recipient countries in the world, indicating the attractiveness of this region for investors.

Main destination of Greenfield investment are developing and transition economies, while M&A activities including cross border deals remain the main form of FDI in the developed world.[2]

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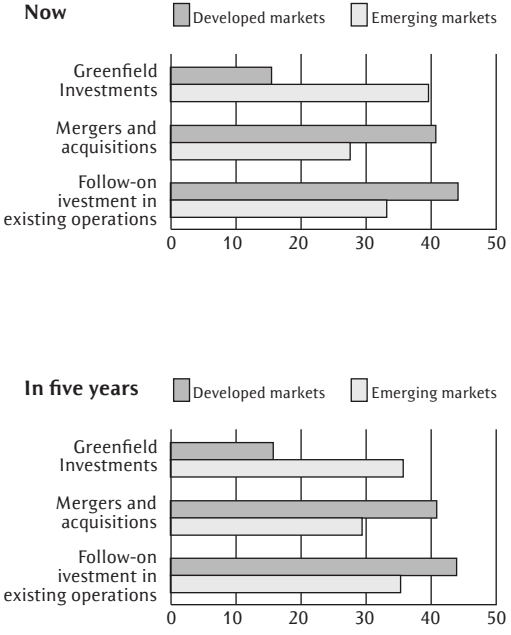
1 Detailed data can be found in Table A2 in the Annex to this Chapter.

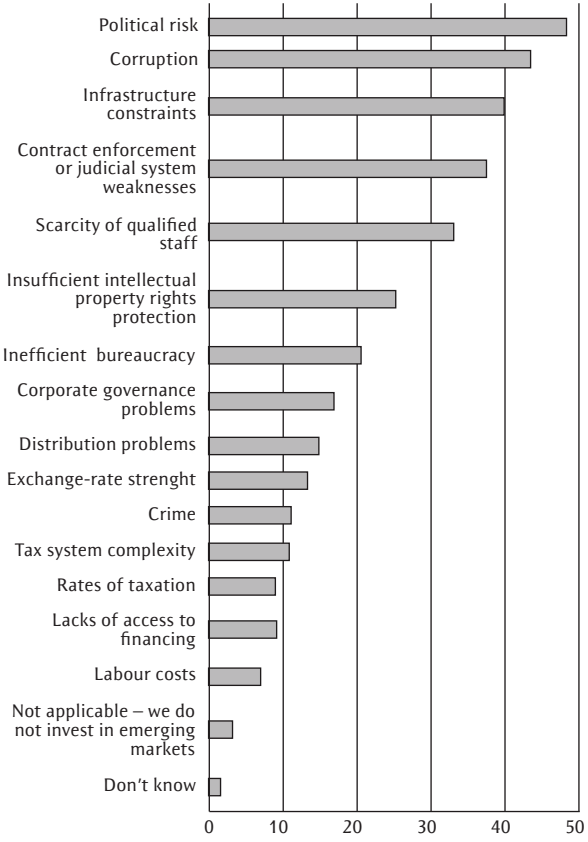
2 "Two main forms of FDI can be distinguished: Greenfield FDI is a new investment made by setting up a new foreign affiliate, while cross-border M&As involve a change in the control of assets and operations of the merged or acquired firm. In a cross-border merger the assets and operations of the two firms are combined to establish a new entity whose control resides in a team from one or both of the two. In a cross-border acquisition the control of assets and operations is transferred from one company to the other (foreign) company, the former becoming an affiliate of the acquirer. Both firms may be private or state-owned: privatization involving a foreign investor counts as cross-border M&A" UNCTAD, TAD/INF/PR/055. A broader definition (of LOCOmonitor) includes five main forms of FDI: Greenfield investment (a new operation), Brownfield investment (expansions or re-investment in existing foreign affiliates or sites), Mergers & Acquisitions (M&As), Privatization and equity investment and New forms of investment (joint ventures, strategic alliances, licensing and other partnership agreements).

Figure 2 Greenfield investments and constraints for FDIs

Which forms of investment in developed and emerging markets are most important now and in five years?
(% of respondents)



Which of the following represent the most significant constraints on your company's plans to invest to emerging markets? Select up to four.
(% of respondents)



Source: Economist Intelligence Unit survey, June 2007.

Box 1
Are Greenfield investments better than M&As?

It is commonly perceived nowadays that after only a few years of operation one cannot easily distinguish FDIs by mode of entry. UNCTAD World Investment Report suggests that, *especially at the time of entry and in the short term*, Greenfield investments involve, in some respects, greater benefits or smaller negative impacts from the perspective of host-country development.

Both modes of FDI entry bring foreign capital to a host country but financial resources provided through M&As do not always add to the capital stock, while in the case of Greenfield FDI they do. Hence a given amount of FDI through M&As may correspond to a smaller productive investment than the same amount of Greenfield FDI, or to none at all. However, when the only realistic alternative for a local firm is closure, cross-border merger or acquisition can serve as a "life preserver".

FDI through M&As is less likely to transfer new or better technologies or skills than Greenfield FDI, at least at the time of entry. M&As may lead directly to the downgrading or closure of local production or functional activities (e.g. R&D), or to their relocation in line with the acquirers' corporate strategy.

FDI through M&As does not generate employment when it enters a country. It may lead to lay-offs, although in the case of a firm which would have gone bankrupt if it had not been acquired, it can also maintain employment. Greenfield FDI, by contrast, necessarily creates new employment at entry.

FDI through M&As can increase concentration and lead to anti-competitive results. It can also, however, prevent concentration from increasing when takeovers help preserve local firms that might otherwise have gone under. Greenfield FDI, by definition, increases the number of firms in existence and does not increase market concentration upon entry. Source: UNCTAD WIR 2000.

In the longer term many differences between the two modes diminish or disappear. M&As often tend to invest in production, just as Greenfield FDI does (brownfield), and in the transfer of new or better technology, especially after acquired firms go through restructuring. Differences between the two modes with regards to employment generation tend to diminish over time and depend more on the motivation for entry than on the mode of entry. Concerns remain in developed and developing countries particularly about the market power of transnational corporations (TNCs) and potential anti-competitive implications of M&As.

According to the EIU survey of multinational corporations (MNCs), Greenfield investments would continue to be their primary route for investment into emerging markets in the coming five years. M&As lag behind, and the share of those who cited M&As as the preferred mode of investing in emerging markets rose only slightly for 2007-11 plans compared with the situation in the previous five-year period.

The forecasts of FDI growth indicate an overall slowdown and nominal decline in 2008 before renewed growth in 2009-11 increases annual FDI flows to USD 1.6trn. EIU survey of MNC respondents indicates that investors are willing to resume FDI activities in future. Over 40% MNCs reported expectations of a "substantial increase" of investments outside their home markets over the coming five-year period compared with the previous five years, and 52% said that they would increase their foreign investment "moderately". Thus more than 90% expect their investments to increase; fewer than 1% of respondents expect to reduce substantially their foreign investments in 2007-11.[3] A widespread concern remains about political violence in leading countries such as the US and the UK, and apparent sensitivity to a range of geopolitical risks. But opportunities appear to predominate over political risk concerns, despite the fact that a considerably greater threat to business is foreseen over the next five years than in the recent past.[4]

Table 3 Foreign direct investment inflows in SEE, 2002-2011, (USD bn)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Bulgaria	0.9	2.1	3.5	3.9	5.2	3.5	2.3	2.3	2.4	2.5
Croatia	1.1	2.0	1.2	1.8	3.6	2.5	2.7	2.5	2.5	2.7
Hungary	3.0	2.21	4.5	7.50	6.1	4.82	4.8	5.9	5.4	4.8
Romania	1.1	1.8	6.4	6.5	11.4	9.8	7.2	7.3	7.0	7.2
Russia	3.5	8.0	15.4	12.8	28.7	35.0	29.0	30.0	31.0	32.0
Serbia	0.5	1.4	1.0	1.5	4.3	2.2	3.5	2.0	1.9	2.0

Source: EIU (2007), pp. 20

3 Economist Intelligence Unit "**World investment prospects to 2011** – Foreign direct investment and the challenge of political risk"

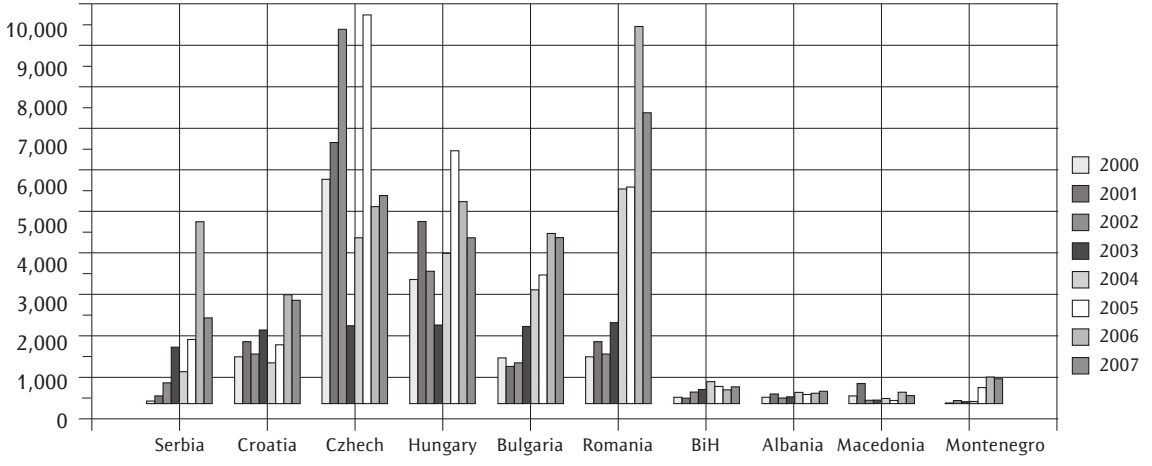
4 Ibidem.

2. FDIs in transition economies of South Eastern Europe

Transition economies during past six years became a record FDI recipient with USD 112bn in 2006, making this region more competitive than Latin America, remaining second only to Asia among emerging markets. Among the ten emerging market FDI recipients in 2006 — three come from this region: Russia (3rd), Poland (8th) and Romania (10th). Total FDI inflows represented 5% of the region's GDP, the highest ratio achieved thus far. As for the Balkans, the FDI inflows/GDP ratio are even larger, exceeding 10% in 2006. This makes FDIs almost four times more intensive in this region than in the world, where average FDI/GDP ratio still did not exceed 2.5%.

Figure 3 indicates that a clear distinction can be made between four SEE countries (Bulgaria, Romania, Croatia and Serbia), on the one side, and the other four SEE countries (BIH, Albania, Macedonia and Montenegro), who attracted several times less abundant FDI flows. But in order to get a right insight, an inspection of stocks has to be made. When stocks are taken into account

Figure 3 Foreign direct investments flows in selected SEE economies, mil. USD,



(Figure 4) it becomes clear that fast Eastern-European reformers (Hungary, Poland and Czech Republic) attracted EUR 40-50 billion, while most successful late reformists (Slovakia, Romania and Bulgaria) attracted almost three times less investments. Croatia and Serbia are reaching EUR 10 billion in 2006, but according to WIIW, foreign direct investments in southeastern Europe in 2007 will retreat from last-year's record-high levels.[5]

The estimates are that FDI inflows into the region of USD 112bn may have peaked in 2006. For 2007 all regions except CIS are forecasted to decline, to a still very high USD 100bn. According to two distinguished FDI forecasters – The Economic Intelligence Unit and The Vienna Institute for International Economic Studies, total FDI inflows are likely to continue to trend downwards, even over the medium term. The main reason for this is the near-exhaustion of major privatization opportunities in much of the region. But sharply increasing labor costs in many countries, continuing business environment problems and competition from other destinations threaten to keep inflows below potential for a number of years ahead.

The experience of successful transition economies shows that Greenfield FDIs lag in the first phase of transition, primarily due to the fact that in the beginning of transition most countries opted for major privatizations – where cross-border M&As play a very useful role, which Greenfield FDI may not be able to play. The advantage of M&As in such conditions is that they restructure existing capacities that would otherwise risk downsizing or closure. In addition, it was only after major privatizations that hard budget constraint is implemented in the economy, which only then makes business environment attractive enough for foreign Greenfield investments.

As a result of successful economic transformation transition economies are highly ranked in attracting Greenfield investments. Table 5 shows Romania ranking 7th on Greenfield projects worldwide with 362 Greenfield investment programs in 2006, followed by Poland, Bulgaria, Hungary, Czech Republic, making transition economies practically one third of the most successful Greenfield locations in the world. Apart from Russia, where natural resources oriented Greenfield investments dominate, in other transition economies their structure is quite different. The relatively large size of these economies, the start of privatization by sale and the introduction of FDI-friendly policies proved as a successful means for attracting FDIs.

5 Database on Foreign Direct Investment in Central, East and Southeast Europe, 2007: Shift to the East

Table 4 Sequencing of FDI during transition

	1990-1995	1996-2000	2000 onwards
Czech R.	Liberalization, local market	Privatization, little Greenfield	Greenfield
Hungary	Liberalization, privatization	Greenfield, export oriented	Greenfield
Slovakia	Little	Liberalization, privatization	Greenfield
Poland	Local market	Privatization, local market	Privatization, local market
Serbia		Some privatization	Liberalization, privatization, some Greenfield

Source: WIIW, 2005, except for Serbia

After a surge in privatization-led FDIs, Greenfield investments are enjoying a resurgence in East-Central Europe. Between 2002 and 2006, over 1000 Greenfield projects were started in regional leader Hungary, approaching the total of Brazil and surpassing those of several EU-15 countries (Spain, Austria, Finland, Denmark, Ireland and Portugal). Poland (709 project starts), Romania (635) and the Czech Republic (499) have also become important Greenfield destinations.[6]

As for the sectoral trends, in major transition economies manufacturing dominates inflows, while natural resources lead outflows. It is important here to distinguish market-seeking FDIs (local market-oriented) from efficiency-seeking FDIs (export-oriented). In the first stage of FDI, market-seeking FDI prevailed. In the second half of the 1990s, more and more efficiency-seeking FDI emerged in manufacturing. At the same time market-seeking FDI expanded in financial and other business services. In the most recent years market-seeking FDI has been confined to newly liberalized utilities. Efficiency-seeking FDI has also appeared in market services. Manufacturing FDI developed from simple efficiency-seeking to a more complex network-type of integrated production.

Export-oriented FDIs in the CEECs is most densely located in countries close to the EU: Estonia, the Czech Republic, Hungary, Poland and Slovakia, both because of the best transport facilities and low transaction costs, while maintaining relatively modest labor costs. Those countries are more advanced in terms of transformation, with efficient institutions and more advanced FDI policies than other transition countries can offer. Lately also Romania and Bulgaria joined the race for export-oriented FDIs.

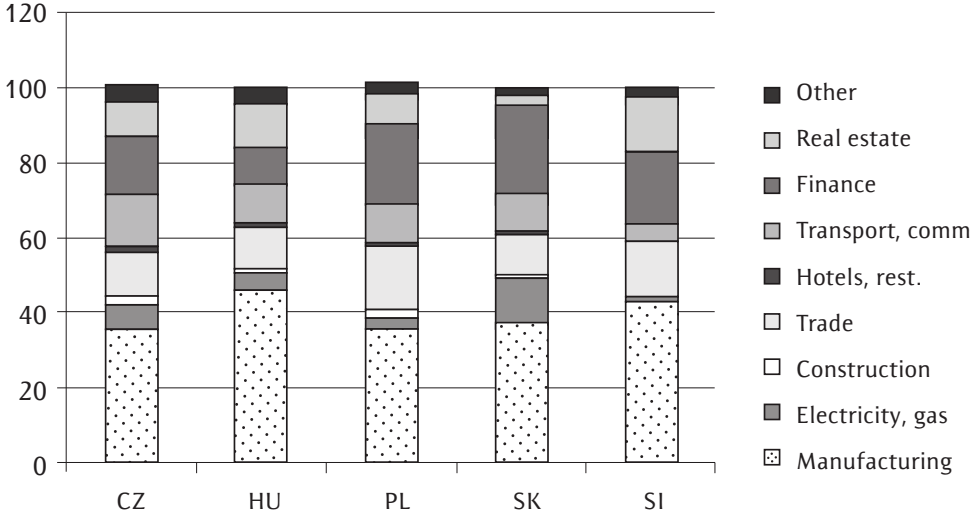
6 FDI magazine, June 2007 and estimates from EIU for 2006.

Table 5 Top 30 Greenfield locations in the world

	2005		2006		
	No.	Share in world total (%)	No.	Share in world total (%)	% change, year on year
1. China	1,237	11.84	1,370	11.66	11.4
2. India	590	5.65	979	8.29	65.9
3. US	563	5.39	725	6.14	28.8
4. UK	633	6.06	668	5.65	5.5
5. France	489	4.68	582	4.93	19.0
6. Russia	511	4.89	386	3.27	-24.5
7. Romania	261	2.50	362	3.06	38.7
8. Germany	271	2.59	333	2.82	22.9
9. Poland	271	2.59	324	2.74	19.6
10. Bulgaria	140	1.34	286	2.42	104.3
11. UAE	226	2.16	282	2.39	24.8
12. Spain	152	1.46	242	2.05	59.2
13. Hungary	206	1.97	235	1.9	14.1
14. Vietnam	169	1.62	196	1.66	16.0
15. Singapore	159	1.52	189	1.60	18.9
16. Canada	206	1.97	177	1.50	-14.1
17. Czech Republic	149	1.43	174	1.47	16.8
18. Mexico	137	1.31	170	1.44	24.1
19. Hong Kong	125	1.20	151	1.28	20.8
20. Japan	121	1.16	145	1.23	19.8
21. Brazil	170	1.63	145	1.23	-14.7
22. Ireland	193	1.85	140	1.19	-27.5
23. Italy	140	1.34	138	1.17	-1.4
24. Netherlands	109	1.04	129	1.09	18.3
25. Australia	110	1.05	126	1.07	14.5
26. Ukraine	125	1.20	124	1.05	-0.8
27. Malaysia	93	0.89	123	1.04	32.3
28. Sweden	105	1.01	120	1.02	14.3
29. Slovakia	118	1.13	115	0.97	-2.5
30. Thailand	117	1.12	111	0.94	-5.1
... Serbia	4*	7*	….	…	...

* SIEPA

Figure 4 Structure of investments in transition economies (average 2000-2006)

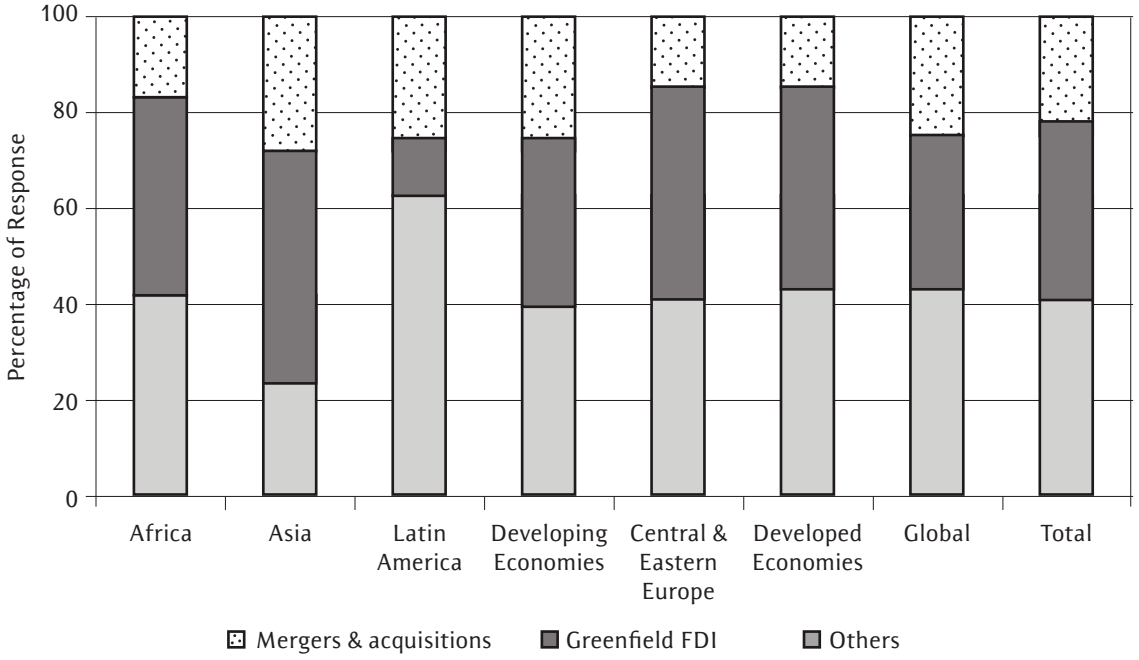


Hungary is ahead of the others concerning the amount invested, but this might change in the years to come due to new Greenfield investments in the Czech Republic and in Slovakia, as well as newcomers to the EU, Bulgaria and Romania.

Numerous surveys are trying to estimate modes of entry for future FDIs. In general, most location experts[7] expect firms to further internationalize their operations using both Greenfield operations and mergers and acquisitions (M&As) (see Figure 6). An UNCTAD survey reveals that these two options receive a similar number of votes (about 40 per cent of the total) as the most likely mode of entry by TNCs. Other non-equity options such as licensing and strategic alliances were mentioned by only some 20 per cent of experts. Greenfield investments are seen as a major (42%) mode of FDI entry in Central and Eastern Europe. This is partly because major privatizations have already been performed, and also because efficiency-seeking investors are estimating good future for this region.

7 EIU, WIIW, UNCTAD, LOCO monitor, etc.

Figure 5 Modes of investment: TNCs use different strategis for different regions (2004–2007)



Source: UNCTAD-DITE, Global Investments Prospects Assessment (GIPA)

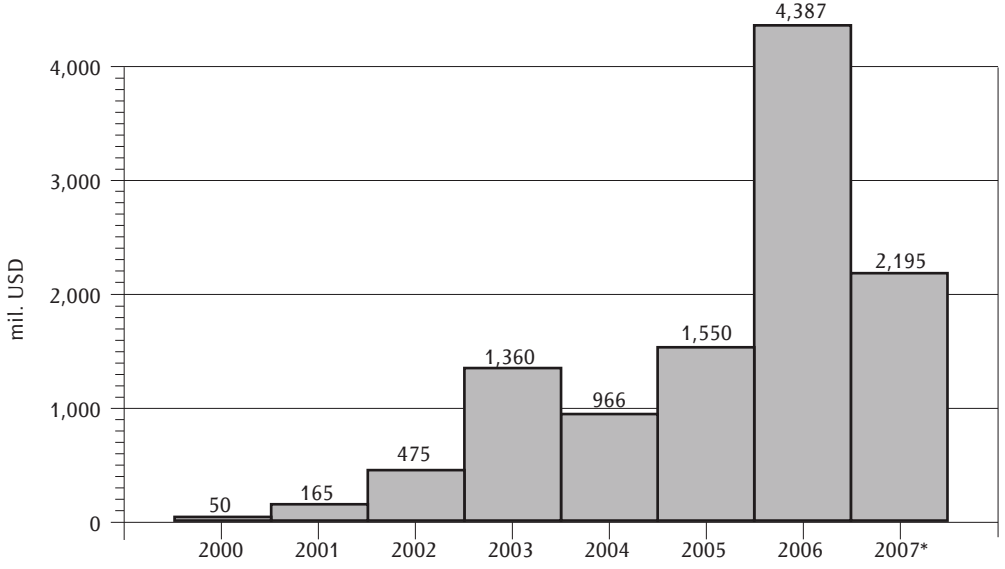
In Central and Eastern Europe, FDI inflows are expected to increase in food and beverages, motor vehicles and other transport equipment and, to a lesser extent, publishing and media, printing and recording, and the electrical and electronics industries. The perception of improved prospects for FDI in the services sector is broad-based and includes industries such as construction and real estate, retail and wholesale trade, transport, education and health, business services, computer-related services, and banking and insurance.[8]

8 UNCTAD Prospects for FDI Flows, Transnational Corporation Strategies and Promotion Policies: 2004–2007, and World Investment Prospects to 2011.

3. FDIs and Greenfield FDIs in Serbia

Owing to a well-chosen privatization method Serbia is evidencing a growing FDI inflows since 2000. The surge in 2006 coincided with peak FDIs in the whole region, and came primarily as a consequence of the privatization of the mobile telecommunications company *Mobtel*, purchased by *Telenor* for almost EUR 1.513 million (slightly less than USD 1.9bn).

Figure 6 FDIs in Serbia, 2000-2007, bn. USD



Source: National Bank of Serbia

The list of most abundant FDI flows by country of origin, sector and by mode of investments is given in Table 6, while Figure 8 gives a further insight in national shares of most important investors.

Table 6 Most abundant FDIs in Serbia

No.	Company	Country of origin	Sector	Type of investment	Sum (mil. EUR)
1	Telenor	Norway	Telecomunications	Privatization	1,513
2	mobilkom austria group	Austria	Telecomunications	Greenfield	570
3	Philip Morris – DIN	USA	Tobacco industry	Privatization	518
4	Stadt	Germany	Industry	Capital market	475
5	Banca Intesa – Delta banka	Italy	Banking	Capital market	462
6	Interbrew – Apatinska pivara	Belgium	Brewery	Capital market	430
7	NBG	Greece	Banking	Privatization	425
8	Mercator	Slovenia	Retail	Greenfield	240
9	Lukoil – Beopetrol	Russia	Oil industry	Privatization	210
10	Holcim – Novi Popovac	Switzerland	Cement	Privatization	185
11	OTP Bank	Hungary	Banking	Privatization	166
12	Alpha Bank – Jubanka	Greece	Banking	Privatization	152
13	U. S. Steel – Sartid	USA	Steel and plate industry	Brownfield	150
14	Metro Cash & Carry	Germany	Wholesale	Greenfield	150
15	OMV	Austria	Gas stations	Greenfield	150
16	Coca Cola	USA	Non-alcohol beverages	Capital market	142
17	Africa Israel Corp. Tidhar	Israel	Real estate	Capital market	120
18	Droga Kolinska Grand prom.	Slovenia	Industry	Greenfield	100

Source: SIEPA

Table 7 FDI in Serbia in period 2000–1 VIII 2007, in USD and in %

No	Country	Thousands of USD 2000 – 1 VIII 2007	%
1	Austria	1,658,234	19
2	Norway	1,550,214	17
3	Greece	1,451,978	16
4	Germany	1,361,833	15
5	Netherlands	476,784	5
6	Slovenia	439,660	5
7	France	413,655	5
8	Luxembourg	374,428	4
9	Hungary	311,877	4
10	Great Britain	273,408	3
	Others	581,994	7
	Total	8,894,065	100

But many obstacles remain for more abundant FDIs to come to Serbia. According to Foreign Investors Council, the investors are mainly concerned with public sector salary increases, which might aggravate the pressure on inflation and ingrained corruption, as well as the still unreformed judiciary. Serbia's "socialist" labor laws are overly protective of workers and do not stimulate job creation. In addition, the current system of rental of construction land hinders the establishment of capital funds. Real estate market also suffers from the procedure for issuing construction permits, which remains undefined. The Council has put forward several concrete recommendations. Efforts need to be increased in terms of copyright protection and the curbing of piracy. The already drafted law on takeovers needs to be adopted. Finally, restitution of property seized under communism is a precondition for fair relations in the real-estate sector – the backbone of the whole economy.[9]

9 FIC report, 2007.

Figure 7 Total FDI per capita and share in GDP

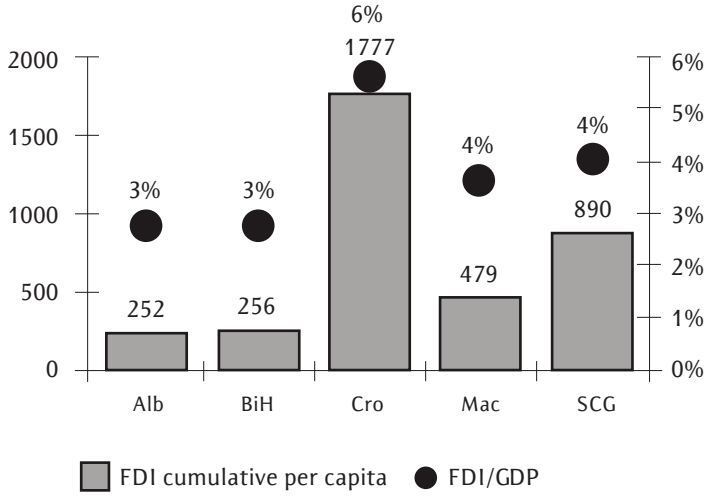


Table 8

No.	Company	Country of origin	Sector	Investment type	Sum (mil. EUR)
1	Merkur	Slovenia	Retail	Greenfield	60
2	Ball Corporation	USA	Packaging	Greenfield	60
3	GTC International	Netherlands	Real estate	Greenfield	58
4	Hellenic Petroleum	Greece	Energy	Greenfield	50
5	Veropulos	Greece	Retail	Greenfield	34
6	Laiki Bank – Centrobanka	Cyprus	Banking	Capital market	33
7	Neochimiki – Rafinerija nafte Beograd	Greece	Energy	Privatization	31
8	General Group – Delta osiguranje	Italy	Insurance	Capital market	30
9	Grawe	Austria	Insurance	Greenfield	30
10	Hotel IN	Greece	Tourism	Greenfield	20

Source: SIEPA

Thus Greenfield investments such as the *American Ball Packaging* and the *Microsoft Development Centre* or *Vip mobile* remain an exception.

When FDI stock is concerned, it becomes obvious that it still is very low – making only a half of FDIs per capita in Croatia and remaining several times lower than in more advanced transition economies.

Concerns about present FDI inflows remain also because investments mainly entered by the nontradables sectors – banking, insurance, energy, telecom, real estate and retailing. From the growth perspective, the most sustainable are FDI flows that boost productivity and technological upgrading, especially in the tradables sector, as they boost competitiveness and exports. Nontradables sector inflows can be more worrisome—while they may improve productivity, if they do not generate foreign currency earnings. Large inflows to nontradables sectors, especially into real estate, have often led to credit booms, rising asset prices and wages, and to additional shifts in production from the tradables to the nontradables sector. With rising demand for imports and a declining supply of tradables, current account deficits can continue to widen.

In that respects, Serbia remains a country with smallest share of tradables, which should be a serious warning to economic policy makers when analyzing results of recent FDI.

Table 9 Emerging Europe: Share of FDI in Tradables
Percent, stock, 2005 or latest available

	Bulgaria	Romania	Croatia	Serbia	CEES	Baltics
Tradables (manufacturing and mining)	22	46	36	20	42	10
Nontradables	78	54	64	80	58	80
Trade	13	15	8	23	14	14
Transport	26	12	16	0	7	9
Financial interm.	20	11	28	37	18	27
Real estate	9	6	2	12	11	15

Sources: WIIW, NBS

Empirical studies have shown that growth tends to be more sustainable in countries with strongly performing tradables sectors.[10] Ireland is an example in Europe of rapid and sustainable catch-up with large capital inflows, in particular FDI, that boosted export production.

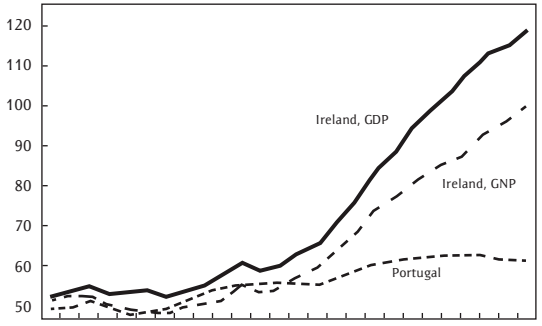
10 Johnson and others (2006), Rodrik (2006), and Jones and Olken (2005)),

Portugal, on the other hand, is an example of stalled catch-up, with large inflows of capital into consumption and investments in nontradables, including real estate. The widening current account deficit became unsustainable as competitiveness was lost following real exchange rate appreciation, and the boom turned bust as growth slowed down (Box 2).

Box 2
Catch-Up: The Different Experiences of Ireland and Portugal

Ireland and Portugal offer an interesting contrast on the sustainability of catch-up.

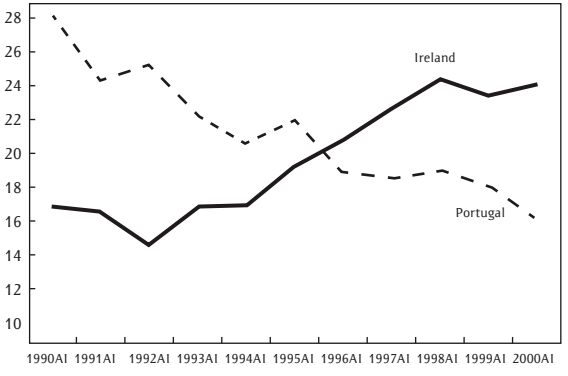
Between the mid-1980s and euro adoption in 2000, both Ireland and Portugal were catching up. From 2000 on, however, Ireland continued to catch up, while Portugal started to revert.



The main differences are in wage policy and the use of the capital inflows.

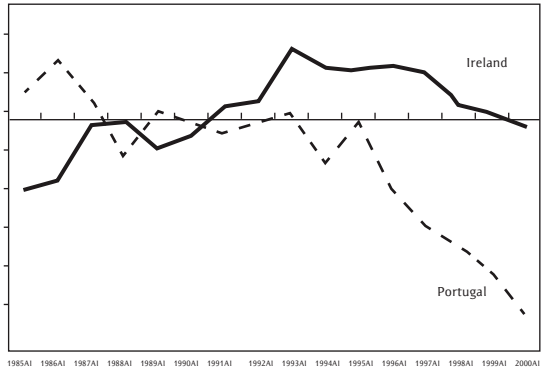
In Ireland, large FDI flows into the manufacturing sectorcontributed to a sharp increase of the tradables sector, anexport boom, and a rapid rise of total factor productivity (TFP). As wages lagged TFP, the unit-labor-cost-based REER declined sharply, boosting profitability of the export sector and leading to a sharp increase in corporate saving. As government saving increased as well, the investment boom did not worsen the current account—on the contrary, savings increased faster than investment, and the current account balance moved into surplus.

Ireland and Portugal Saving (% of GDP)



In Portugal, large capital inflows—in the nontradables sector rather than manufacturing—fed a domestic demand boom and a surge in imports. In the absence of a large presence of foreign firms, TFP growth lagged. As wage growth exceeded TFP, profit margins in the export sector were squeezed, stimulating a decline of the tradables sector. With little improvement in the government balance and a decline in corporate savings, total saving declined, widening the current account deficit.

Ireland and Portugal: Current Account Balances (in percent of GDP)



In short, Ireland and Portugal had a different catch-up model. Ireland caught up through an expansion of supply and of the tradables sector; Portugal through expanding demand and of the nontradables sector.

The problem in Portugal arose when the boom came to a halt in 2001 and GDP stagnated. Labor productivity growth stopped, leading to a further deterioration of competitiveness, which maintained the current account deficit high. Portugal was in a slump but could not get out of it. With high and increasing fiscal deficits, and no independent monetary policy, there was no room to stimulate domestic demand. But the tradables sector had become too uncompetitive to drive the economy, yet with euro membership, exchange rate adjustment was no longer an option.

Why was Ireland so successful in attracting FDI in manufacturing? Both good policies and fortunate circumstances were important. Good policies included prudent fiscal policy, low taxes on labor and business income, and flexible labor and product markets. Fortunate circumstances included favorable demographics and participation in the EMU.

Source: IMF Working Paper, **Vulnerabilities in Emerging Southeastern Europe—How Much Cause for Concern? October** 2007.

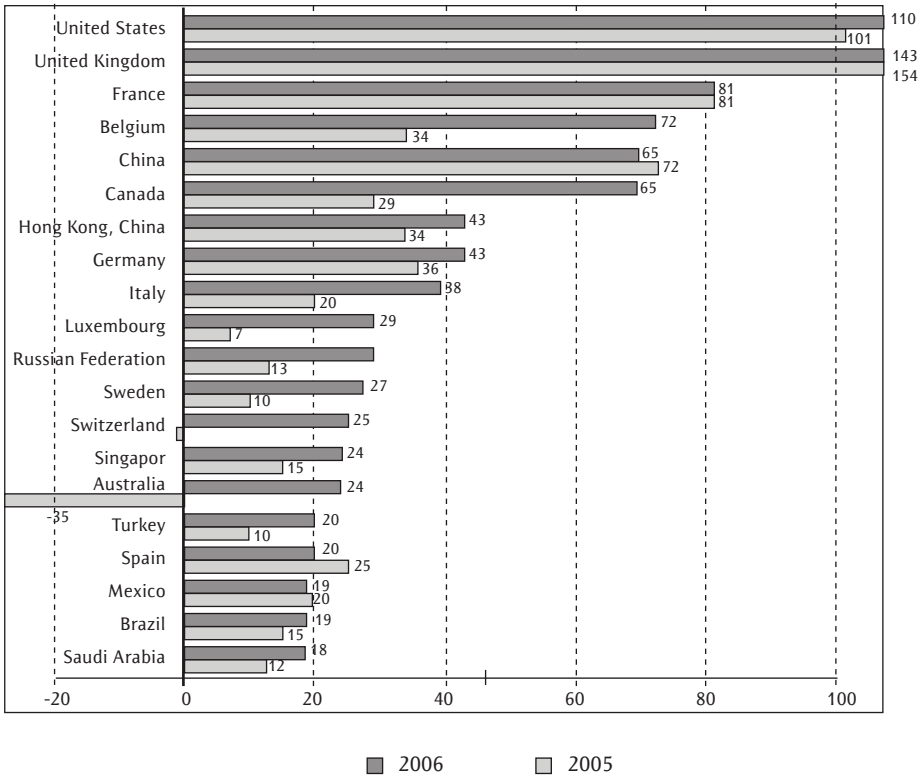
Appendix

Table A1
Foreign direct investment projections
(USD bn unless otherwise indicated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
World FDI inflows	**618.1**	**563.4**	**730.2**	**971.7**	**1,335.1**	**1,474.7**	**1,406.4**	**1,470.3**	**1,536.8**	**1,604.0**
% change, year on year	-27.4	-8.8	29.6	33.1	37.4	10.5	-4.6	4.5	4.5	4.4
% of GDP	1.9	1.5	1.8	2.2	2.8	2.8	2.5	2.5	2.4	2.4
FDI inflows to developed countries	**421.1**	**354.6**	**379.5**	**546.8**	**824.4**	**940.2**	**879.0**	**925.5**	**972.6**	**1017.3**
% change, year on year	-25.2	-15.8	7.0	44.1	50.7	14.0	-6.5	5.3	5.1	4.6
% of GDP	1.7	1.3	1.2	1.7	2.4	2.6	2.3	2.3	2.3	2.4
% of world total	68.1	62.9	52.0	56.3	61.7	63.8	62.5	62.9	63.3	63.4
FDI inflows to emerging markets	**197.0**	**208.9**	**350.7**	**424.9**	**510.7**	**534.6**	**527.4**	**544.8**	**564.2**	**586.7**
% change, year on year	-31.5	6.0	67.9	21.1	20.2	4.7	-1.3	3.3	3.6	4.0
% of GDP	2.5	2.4	3.4	3.5	3.6	3.3	2.9	2.7	2.6	2.4
% of world total	31.9	37.1	48.0	43.7	38.3	36.2	37.5	37.1	36.7	36.6
World stock of inward FDI	**7,185**	**8,615**	**9,981**	**10,455**	**12,216**	**13,622**	**14,955**	**16,347**	**17,796**	**19,307**
% change, year on year	11.4	19.9	15.9	4.7	16.9	11.5	9.8	9.3	8.9	8.5
% of GDP	22.1	23.6	24.3	23.6	25.6	25.9	26.5	27.4	28.3	29.0
Developed country stock of inward FDI	**5,151**	**6,246**	**7,189**	**7,265**	**8,510**	**9,441**	**10,306**	**11,216**	**12,171**	**13,169**
% change, year on year	20.7	21.2	15.1	1.1	17.1	10.9	9.2	8.8	8.5	8.2
% of GDP	20.6	22.2	23.0	22.3	24.9	25.6	26.4	27.8	29.2	30.4
% of world total	71.7	72.5	72.0	69.5	69.7	69.3	68.9	68.6	68.4	68.2
Emerging markets stock of inward FDI	**2,034**	**2,369**	**2,792**	**3,189**	**3,706**	**4,181**	**4,649**	**5,130**	**5,626**	**6,139**
% change, year on year	-6.8	16.5	17.9	14.2	16.2	12.8	11.2	10.4	9.7	9.1
% of GDP	26.2	27.1	27.2	26.3	26.3	25.7	25.6	25.7	25.6	25.3
% of world total	28.3	27.5	28.0	30.5	30.3	30.7	31.1	31.4	31.6	31.8

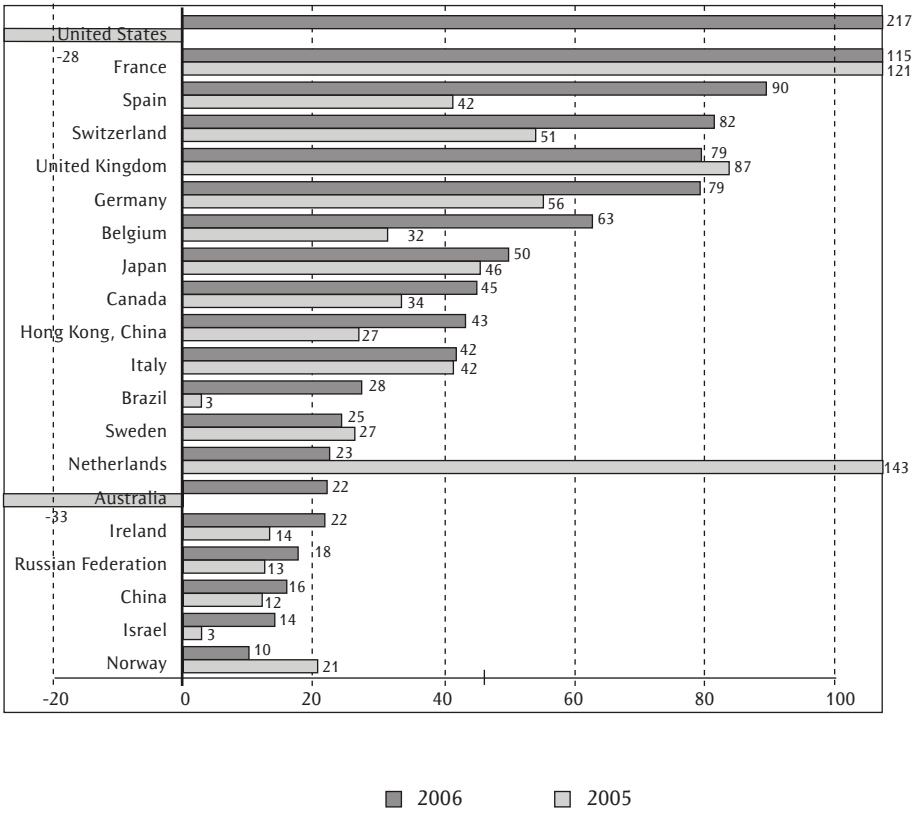
Sources: National statistics; IMF; OECD; UNCTAD; all forecasts are from the Economist Intelligence Unit.

Figure A1 Global FDI inflows, top 20 host economies, 2005-2006[a] (billions of dollars)



Source: UNCTAD, World Investment Report 2007
Note: [a] Ranked by the magnitude of 2006 FDI outflows

Figure A2 Global FDI outflows, top 20 investors, 2005-2006[a] (billions of dollars)



Source: UNCTAD, World Investment Report 2007
Note: [a] Ranked by the magnitude of 2006 FDI outflows

Table A2 Number of FDI projects by sector

	2003	2004	2005	2006	2003-06 total	% of total
Software & IT services	937	1,189	1,197	1,264	4,587	10.93
Financial services	633	641	787	1,094	3,155	7.52
Food & tobacco	571	623	598	623	2,415	5.76
Business services	414	543	559	725	2,241	5.34
Textiles	421	590	410	498	1,919	4.57
Consumer products	396	431	404	585	1,816	4.33
Metals	433	371	540	441	1,785	4.25
Communications	338	361	521	548	1,768	4.21
Industrial machinery, equipment & tools	318	399	422	498	1,637	3.90
Chemicals	438	416	314	370	1,538	3.67
Automotive components	381	404	348	359	1,492	3.56
Real estate	238	229	263	495	1,225	2.92
Automotive OEM	354	337	316	308	1,315	3.13
Electronic components	266	315	353	344	1,278	3.05
Coal, oil & gas	436	257	328	278	1,299	3.10
Transportation	176	264	362	379	1,181	2.82
Hotels & tourism	305	288	265	293	1,151	2.74
Plastics	224	230	233	262	949	2.26
Consumer electronics	250	229	238	194	911	2.17
Semiconductors	218	247	183	222	870	2.07
Pharmaceuticals	208	204	199	192	803	1.91
Leisure & entertainment	212	186	129	173	700	1.67
Building & construction materials	130	145	156	186	617	1.47
Business machines & equipment	129	178	175	146	628	1.50
Warehousing & storage	112	154	152	181	599	1.43
Paper, printing & packaging	133	130	126	116	505	1.20

	2003	2004	2005	2006	2003-06 total	% of total
Beverages	139	157	95	122	513	1.22
Aerospace	89	102	112	139	442	1.05
Alternative/renewable energy	48	41	75	168	332	0.79
Medical devices	82	90	91	127	390	0.93
Wood products	105	96	100	74	375	0.89
Biotechnology	46	68	74	79	267	0.64
Rubber	52	62	74	70	258	0.62
Engines & turbines	53	52	47	70	222	0.53
Non-automotive transport OEM	41	56	49	55	201	0.48
Healthcare	49	47	37	51	184	0.44
Ceramics & glass	38	41	36	32	147	0.35
Minerals	36	27	50	22	135	0.32
Space & defence	18	25	27	31	101	0.24
Overall total.	**9,467**	**10,225**	**10,445**	**11,814**	**41,951**	**100.00**

Source: LOCOmonitor

Table A3 Overview of FDI in Central, East and Southeast Europe

	FDI inflow, EUR million								Per capita forecast inflow EUR	Per capita stock EUR
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2006**	**2006**
Czech Republic	5404	6295	9012	1863	4007	9374	4752	5000	463	5719
Hungary	2998	4391	3185	1888	3633	6099	4874	4000	484	6170
Poland	10334	6372	4371	4067	10292	7703	11093	12000	291	2361
Slovakia	2089	1768	4397	1914	2441	1694	3324	3000	617	3338
Slovenia	149	412	1722	271	665	445	303	400	151	3133
New Member States 5	20974	19240	22687	10002	21039	25315	24346	24400	370	3571
Estonia	425	603	307	822	776	2349	1282	1300	964	9232
Latvia	447	147	269	270	513	582	1303	1300	589	2615
Lithuania	412	499	772	160	623	826	1426	1300	420	2462
New Member States 8	22258	20439	24035	13795	22950	29072	28357	28300	389	3590
Bulgaria	1103	903	980	1851	2736	3103	4104	4000	583	2047
Romania	1147	1294	1212	1946	5183	5213	9082	7000	421	1432
New Member States 10	24508	22685	26226	15051	30869	37387	41544	39300	407	3019
Albania	155	232	143	158	278	224	259	300	82	603
Bosnia and Herzegovina	159	133	282	338	534	421	338	400	88	676
Croatia	1138	1502	1197	1785	990	1425	2838	2500	639	4577
Macedonia	189	493	83	84	126	80	279	200	137	1028
Serbia	55	184	504	1204	777	1265	3504	3500	471	1119
Montenegro	-	5	76	44	53	393	644	600	1031	1943
Southeast Europe	1696	2549	2285	3612	2759	3808	7862	7500	365	1683
Belarus	129	107	262	152	132	245	282	300	29	214
Moldova	138	115	89	65	120	160	177	200	45	250
Russia	2933	3069	3660	7041	12422	10258	23047	25000	162	1150
Ukraine	644	884	734	1260	1380	6263	4148	5000	89	370
European CIS	3844	4175	4745	8518	14053	16926	27654	30500	136	914
Central and Eastern Europe	30048	29409	33255	27180	47682	58121	77060	77300	236	1625

Source: wiiw database on FDI 2007 and wiiw forecast.

Table A4 Foreign direct investment inflows into eastern Europe

	2006 (USD bn)	2007-11 av (USD bn)	% of regional total
East-central Europe	31.2	**26.4**	**27.2**
Czech Republic	6.0	5.4	5.6
Hungary	6.1	5.1	5.3
Poland	14.5	12.6	13.0
Slovakia	4.2	2.2	2.3
Slovenia	0.4	1.0	1.1
Balkans	**27.1**	**18.1**	**18.7**
Albania	0.3	0.5	0.5
Bosnia and Hercegovina	0.4	1.1	1.1
Bulgaria	5.2	2.6	2.7
Croatia	3.6	2.6	2.7
Macedonia	0.4	0.4	0.4
Montenegro	0.6	0.5	0.5
Romania	11.4	7.7	8.0
Serbia	5.6	2.8	2.9
Baltics	**5.0**	**3.6**	**3.8**
Estonia	1.6	1.4	1.4
Latvia	1.6	1.0	1.1
Lithuania	1.8	1.2	1.3
CIS	**42.2**	**48.7**	**50.3**
Russia	28.7	31.4	32.4
Ukraine	5.2	4.9	5.1
Belarus	0.4	1.0	1.1
Moldova	0.2	0.3	0.3
Armenia	0.3	0.4	0.4
Azerbaijan	-0.7	1.6	1.7
Georgia	1.0	0.9	0.9
Kazakhstan	6.1	6.7	7.0
Kyrgyz Republic	0.1	0.2	0.2
Tajikistan	0.3	0.4	0.4
Turkmenistan	0.3	0.4	0.4
Uzbekistan	0.3	0.4	0.4
East Europe total	**105.9**	**96.8**	100.0

Source: World Investments Prospects to 2011.

Chapter II

Direct effects of Greenfield FDIs

1. The effects of Greenfield FDIs on economic growth

While it is generally accepted that a firm correlation exists between the speed of economic growth and the inflow of FDIs, the direction of causality is not clear: a link between the two phenomena is proved, but the direction in which it works is not all that clear. It is intuitively clear, on the other hand, that Greenfield investments affect growth differently than other FDIs. Since Greenfield FDIs involve mainly (although not only) new capital assets, while privatizations and M&As are just transfers of existing ones, Greenfield FDI would seem more likely to affect growth - if at all – via increased physical investment, while M&A FDI would be more likely to do so via enhanced productivity growth. In fact, the increased importance of M&A in total FDI flows in recent years has been singled out as the likely cause of an observed weakening in the empirical FDI investment link in the 1990s (World Bank, 2001. "Global Development Finance 2001". Washington, D. C., 2001).

Figure 1 Relationship between FDI inflows as a share of GDP and per capita GDP growth (average 1995–2004, in %)

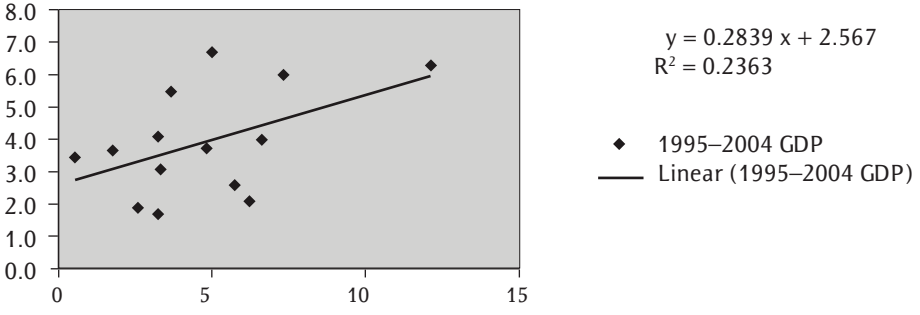
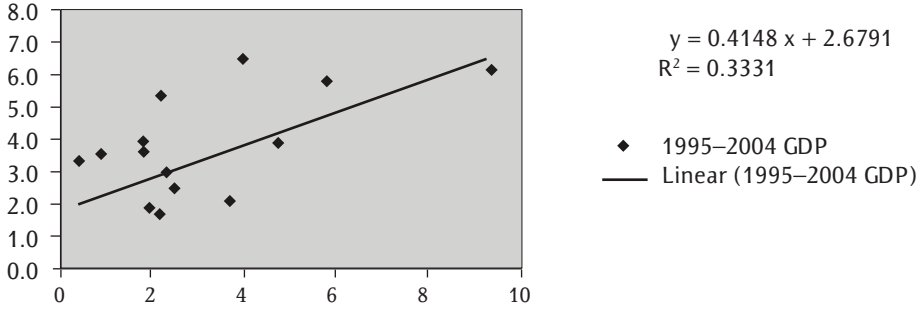


Figure 2 Relationship between Greenfield FDI inflows as a share of GDP growth rate



Figures 1 and 2 indicate that Greenfield inflows affect growth more strongly than overall investments[1]. Figure 1 shows a relation between total FDIs and per capita growth rate. It shows that FDI has a positive and significant impact – at the 8% level – on per capita GDP growth rate: a 1% point increase of FDI inflows in GDP accounts for an increase of 0.3% point of per capita GDP growth. As FDI contributes to investments (GFCF, i.e. gross fixed capital formation) to the extent to which it does not consist of acquisition of existing assets, brownfield FDIs have been deduced (proxy by the sales of existing companies to foreign investors) from FDI inflows to obtain a measure of Greenfield FDI. In that case, FDI has a larger positive and significant impact – at the 3 % level – on per capita GDP growth rate: a 1% point increase of FDI inflows in GDP accounts for an increase of 0.42% point of per capita GDP growth.

Two questions of importance remain. The first one is about the continuation of the FDI boom to developing countries; specifically, would it continue after the privatization process and the ensuing expansion of cross-border M&A had dried up? That is, would investment in new assets follow an increase in cross-border M&A (the purchase of existing assets)? Table 1 indicates that an expansion of M&A is indeed followed by an increase in Greenfield FDI.

1 Sandrine Levasseur, **Convergence and FDI in an enlarged EU: What can we learn from the experience of Cohesion countries for the CEECs?** Research Department, OFCE-Paris, 2004.

Table 1 Stylized facts on growth and FDIs
Summary of Results

	Industrial Countries	Developing Countries	Latin America
From Greenfield FDI to M&As	-	+	-
From M&As to Greenfield FDI	+	+	+
From Greenfield FDI to Domestic Investment	+	+	+
From Domestic Investment to Greenfield FDI	-	-	-
From M&As to Domestic Investment	+	+	+
From Domestic Investment to M&As	-	-	-
From Greenfield FDI to Economic Growth	-	-	-
From Economic Growth to Greenfield FDI	+	+	+
From M&As to Economic Growth	-	-	-
From Economic Growth to M&As	+	+	+

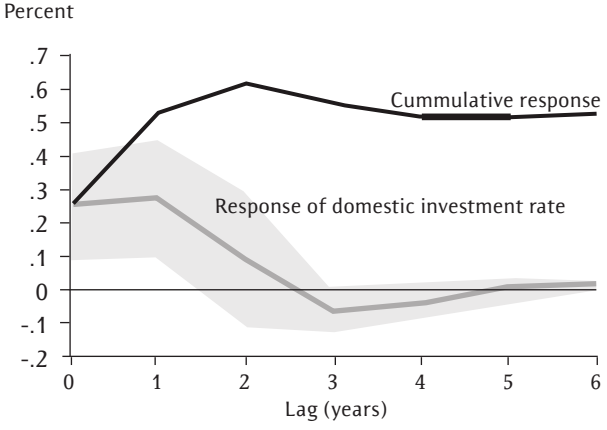
According to estimates, an increase in M&A by 1 % of GDP leads to a rise in Greenfield FDI by about 1 and 1.5 percentage points of GDP in industrial and developing countries, respectively. That is, the subsequent expansion of Greenfield FDI is at least as large as the initial increase in M&A, and substantially more in developing economies. Therefore, if the experience of the 1990s and late 1980s is a good predictor for the future, an expansion of Greenfield FDI will ensure that the FDI boom will continue in the future even after the privatization process has stopped.[2] Experiences of most advanced transition economies fully confirm this numerical result.

The second question concerns the causality (in the sense of time precedence) between the two forms of FDI and domestic investment and economic growth. The results were that both Greenfield and M&A FDI lead domestic investment but are led by GDP growth. Therefore, economic growth, as the most important indicator of domestic rates of return, serves as an effective "pull" factor for foreign investment; and in turn, FDI helps increase domestic investment in future[3].

2 Calderón, Loayza, Servén, GREENFIELD FOREIGN DIRECT INVESTMENT AND MERGERS AND ACQUISITIONS: FEEDBACK AND MACROECONOMIC EFFECTS*, World Bank Policy Research Working Paper 3192, January 2004

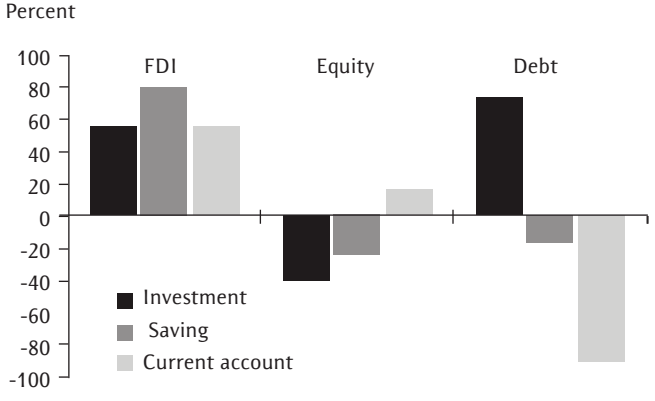
3 In order to close the virtuous circle between FDI, domestic investment, and growth, it would be necessary for investment to lead to economic growth. This important link is not empirically verified, whether as a reflection of poor-quality investment (Pritchett 2000) or the fact that economic growth depends on a multitude of factors that cannot be fully captured by developments in FDI or domestic investment (Barro and Sala-i-Martin 1995, 2000). One of the reasons is already mentioned, i.e., not all modes of investments raise capital, and hence no immediate effects on growth emerge.

Figure 3 Domestic Investments responds Positively to FDI



Note: Shaded area represents 95 percent confidence band.
Sources: Lane and Miles Farretti (2006): World Bank WDI Online database; author' calculations.

Figure 4 FDI Has Positive Effect on Both Savings and Investment

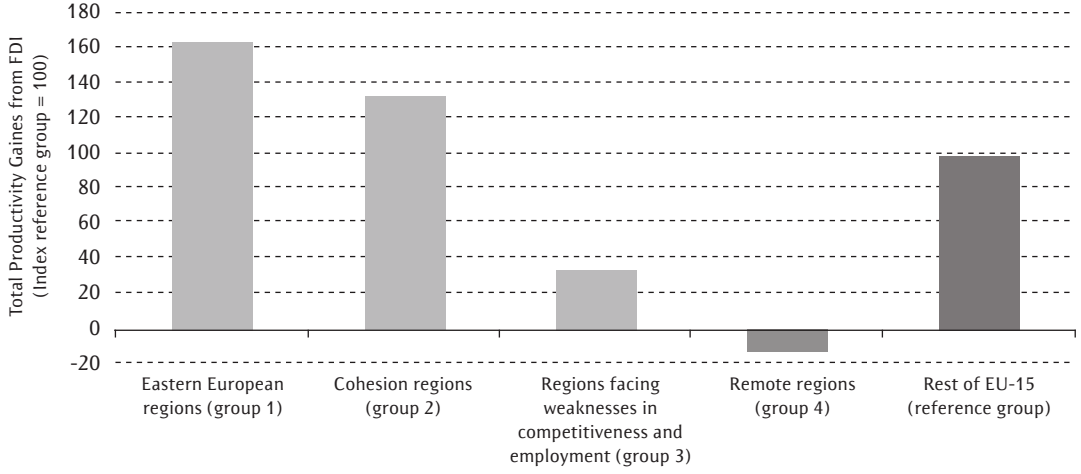


Sources: Lane and Miles Farretti (2006): World Bank WDI Online database; author' calculations.

The most extensive analysis[4] on the impact of FDIs on economic growth for thirteen countries of Central and Eastern Europe over the whole transition period so far - from the fall of the Iron Curtain until now - shows that FDI indeed had a significant positive impact on the rate of economic growth. This also implies that countries which benefited from high FDI inflows attained higher growth rates than otherwise, and countries that were less successful in attracting FDI generated less growth than they might have. In other words, the outcome of the empirical investigation assigns FDI an important role as a growth determinant. Due to its partly endogenous character, FDI will therefore advance to a decisive policy variable, especially for the less developed countries in Central and Eastern Europe, in order to foster the transition process.

The study shows that FDI accounted for about two thirds (2.4%-points) of the average annual growth rate (3.4%). The contributions were positive for all of the thirteen countries, assigning FDI a pivotal role as an engine of economic growth. By contrast, average contributions from domestic investment accounted for only 13% (0.4%-points) of the average annual growth rate.[5]

Figure 5 Total productivity gains from FDI



4 Neuhaus, 2006, The Impact of FDI on Economic Growth, Springer Verlag

5 The only exception is Slovenia, which had a high per capita income but a low inward FDI stock. Dropping Slovenia from the sample improves the relationship between FDI and per capita income significantly. The correlation coefficient jumps to 0.49 and the OLS regression turns out to be significant at the 10 percent level.

The results show that most of the countries were not able to reach higher sustainable domestic investment rates; in some countries the domestic investment rate even shrank. Combing the results for FDI and domestic investment yields some signs of a crowding-out of the domestic capital accumulation sector.

Following the EC study on FDI and regional development, regardless of the type of FDI and regardless of the region groups, the long term effect from FDI induced productivity gains on labor demand are positive.

2. The effects of Greenfield FDIs on employment

The assertion that FDIs would automatically lead to a strong increase in production and employment can often be misleading, since it is not the level of FDI that matters, but the kind of FDI (see Table 2). Only Greenfield (both vertical and horizontal) investment turn out to create new employment in the short run, while other FDI modes operate as a buffer to reductions in overall employment, but show significant cross-country differences.

Table 2 The net effects of FDI on regional labour demand

	General encountered effect on regional labour demand*
(1) Mergers & Acquisitions	-
Greenfield investments	+
(2) Within-industry effect from FDI on local competitor's labour demand	-
Cross-industry effect from productivity knock-on effect	+
(3) Net regional effect	+

Source: Copenhagen Economics.
Note: *) Please note that the table only shows the general encountered effect based on a very large sample of regions and foreign investments, and that the result in specific regions can deviate from this general picture.
Source: The FDI – employment link in a globalizing world, Employment Strategy Dept, 2005.

It is primarily the case because market-seeking investment is always an important motive for FDI but it does not help create much employment, mainly because of rationalization measures in capital-intensive and some service activities. The restructuring of former state-owned enterprises in the wake of privatization often meant massive labor shedding. However, recent literature shows that positive effects on employment growth in privatized firms arise in a range of three to six years after privatization. Experiences of more advanced transition economies are depicted in Table 2.

Table 3 Directions of the change of number of employed persons in the foreign and domestic sectors, 1998–2001

	Total	Foreign	Domestic
Estonia	0	+	-
Czech Republic	+	+	-
Hungary	+	+	+
Poland	-	0	-
Slovak Republic	-	+	-
Slovenia	0	+	-
Romania	-	+	-

Source: wiiw Database on foreign investmententerprises relying on national sources

Regardless of the type of FDI the long term effect from the FDI induced productivity gains on labor demand are positive.[6] A general increase in labor demand is evidenced within regions having many Greenfield investments. In addition, both M&As and Greenfield investments introduce more competition in the local industry and inefficient local firms are driven out. At the same time, productivity gains from both learning effects and from restructuring improves the competitiveness of the remaining industry and the increased demand from the rest of the economy drives up labor demand. FDI in most cases incorporated more modern technology than domestically available and also meant a rise in competitiveness.

The overall state of employment and problems with great unemployment is not a universal problem in all transition economies. Adding here the experience of Serbia, it becomes very

6 UNCTAD, World Investment Report, 2007; European Commission Study on FDI and regional development, Final report, Directorate-General for Regional Policy, Dec. 2006

visible that transition countries usually restricted growth in wages to the level of GDP growth and, with the exception of Poland, this policy had some success in curbing unemployment. In the case of Serbia, strong and persistent annual increase in wages of almost 20% in real terms have left a significant part of the workforce unemployed, while continuous rise in wages in the state owned companies makes work in the private sector less attractive.

As demonstrated in Table 3, in almost all countries faster wage growth was "paid" by a higher unemployment rate.

Table 4 Growth in gross domestic product, productivity and real wages in transition countries, in%

	productivity	GDP	wages	unemployment rate
Bulgaria	5.5	0.7	-6.6	12.7
Czech Republic	6.7	2.0	5.1	10.6
Estonia	…	2.5	4.8	11.0
Hungary	14.6	3.4	0.8	6.0
Latvia	…	0.9	4.8	11.0
Lithuania	…	-1.7	3.1	13.2
Poland	11.3	6.0	6.8	17.9
Romania	7.9	0.6	-2.2	6.3
Slovakia	5.8	4.2	1.6	15.6
Slovenia	8.0	4.8	4.9	8.0
Serbia	5.5	4.7	19.8	21.0

Productivity and GDP from Galgoczi, unemployment from Bishop, K (2001)

Transition economies (especially Poland) have experienced that a policy of delaying privatization or imposing employment requirements on the new owners is likely to mitigate the loss of jobs only temporarily and even then only under favorable circumstances.

The range of potential effects on employment can be then summarized as follows.

Box 1
Direct and indirect effects of FDI on host-country employment

Direct effects:

– Job loss through restructuring of privatized, formerly inefficient state-owned companies.

The need for such restructuring was obvious, but reducing the adverse effect on employment has also been an objective of policymakers. Delaying privatization or imposing employment requirements on the new owner could only temporarily and under favorable circumstances mitigate the loss of workplaces.

– Job creation through Greenfield investment. This has been the main hope of the EU new member states and most of the FDI policy has actually targeted such investments in the manufacturing sector. These hopes have only partially materialized. Most of the Greenfield jobs have been created in the services sector such as banking, retail and real estate.

Indirect effects:

– Job destruction by cutting former domestic linkages after the foreign takeover of a former state-owned enterprise. Foreign investors replace traditional domestic suppliers with imports, generating negative spillovers.

– Job destruction in the domestic SME sector through the competition of larger and technologically more advanced subsidiaries of MNCs. For instance, super-market chains drove out small shops and their suppliers.

Source: Hunya, Geishecker Employment Effects of Foreign Direct Investment in Central and Eastern Europe, WIIW Research Reports

The effects of FDI on wages are generally positive, as TNCs as a whole pay higher wages than local employers. Although data specific to developing-country TNCs are limited, indirect evidence suggests that, at least for skilled labor, they offer higher wages than host-country domestic firms.

In addition to these potential effects, which in principle apply to all kinds of private capital inflows, the gains to host countries from FDI can take several other forms:

- FDI allows the transfer of technology—particularly in the form of new varieties of capital inputs—that cannot be achieved through financial investments or trade in goods and services. FDI can also promote competition in the domestic input market.

- Recipients of FDI often gain employee training in the course of operating the new businesses, which contributes to human capital development in the host country.
- Profits generated by FDI contribute to corporate tax revenues in the host country.

Of course, countries often choose to forgo some of this revenue when they cut corporate tax rates in an attempt to attract FDI from other locations.

Table 5 The range of potential effects

	Direct		**Indirect**	
Area of impact	Positive	Negative	Positive	Negative
Quantity	Adds to net capital and creates jobs in expanding industries.	Foreign direct investment through acquisition may result in rationalization and job loss.	Creates jobs through forward and backward linkages and multiplier effects in local economy.	Reliance on imports or displacement of existing firms results in job loss.
Quality	Pays highes wages and has higher productivity.	Introduces practices in, e g, hiring and promotion that are considered undesirable.	Spill-over of 'best practice' work organization to domestic firms.	Erodes wage levels as domestic firms try to compete.
Location	Adds new and perhaps better jobs to areas with high unemployment.	Crowds already congested urban areas and worsens regional imbalances.	Encourages migration of supplier firms to areas with available labor supply.	Displaces local producers, adding to regional unemployment, if foreign affiliates substitute for local production or rely on imports.

Source: UNCTAD (1994)

3. The effects of Greenfield FDIs on exports

Depending on the type of FDIs, whether it is market or efficiency seeking, FDIs can become successful exporters. The case of Hungary is presented in Table 5, where eight out of ten largest exporters are Greenfield investments, with export share in sales of over 80%.

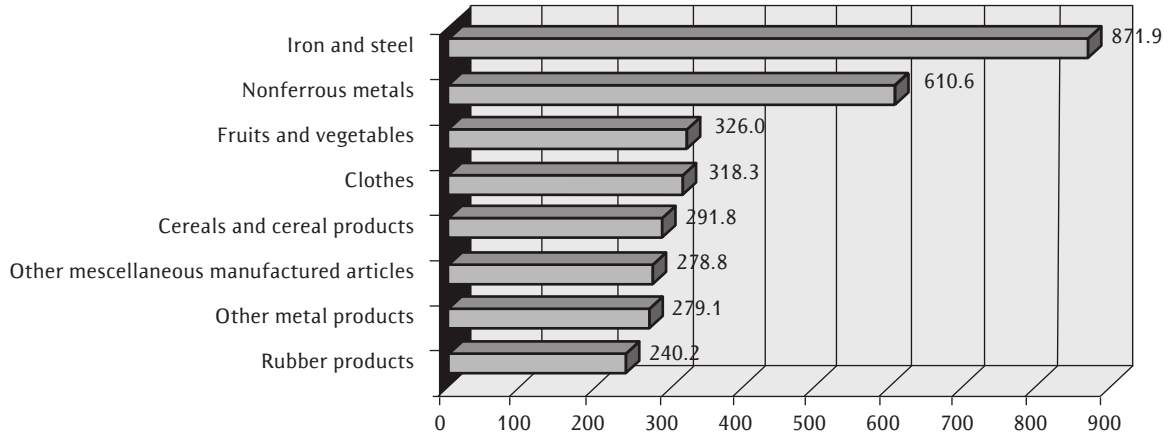
Table 6 Greenfield exporters in Hungary

	Company	With foreign participation?	Export / sales
1	Audi	Yes (Greenfield)	99
2	Flextronics International	Yes (Greenfield)	99
3	Philips Hungary	Yes (Greenfield)	98
4	GE Hungary	Yes (privatization)	94
5	Mol	Partly (publicity traded)	23
6	IBM Storage Products	Yes (Greenfield)	100
7	Open Hungary	Yes (Greenfield)	100
8	Samsung Electronics	Yes (Greenfield)	82
9	Borsodchem	Partly (publicity traded)	81
10	NABI	Yes (Greenfield)	99

Note: only those companies included which provided data on their activities (Nokia!)

Serbia, unfortunately, does not share the experiences of Hungary or Ireland, where Greenfield investors Intel, Dell, Pfizer and HP make up almost 90% of Irish exports.

Figure 6 Major export products in 2006 (mil. USD)



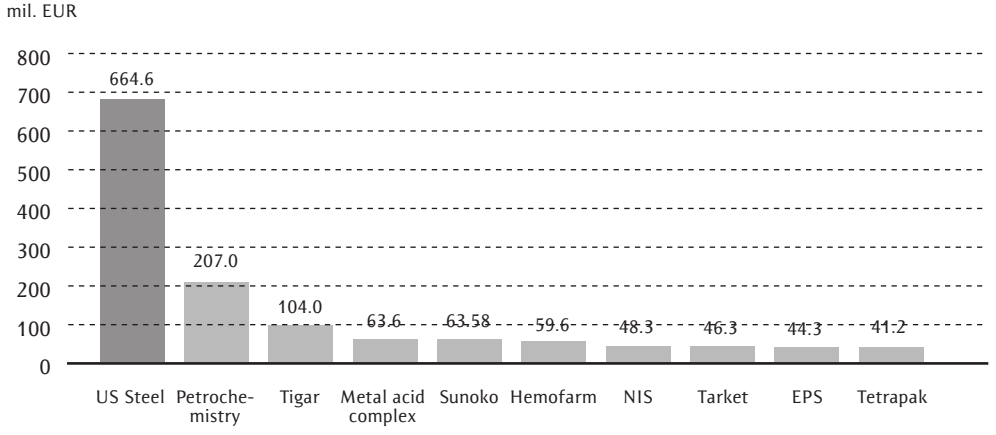
Still, brownfield investor *US Steel* represents the largest Serbian exporter so far. Other investors, like Greenfield *Ball Packaging*, have been extremely successful, but this is unfortunately almost the only case of an efficiency-seeking FDI in Serbia. Most FDIs in Serbia are market-seeking and belong to the non-tradable sector. Still, most of them are extremely important for improving the Serbian business environment – from telecommunications (*Telenor*, *Vip*) to a whole set of FDIs in banking, insurance, and retail. Not only do they raise competitiveness, but they also create an environment which can then become more attractive to efficiency-seeking FDIs. Such efficiency-seeking FDIs are essential for the economic stability of the country, since they help in avoiding balance of payments overheating, which has recently become a serious problem of the Serbian economy.

Box 2
About *U. S. Steel Serbia*, d.o.o and Affiliated Companies

On September 12, 2003, *United States Steel Corporation* purchased the Serbian steel company, *Sartid, a.d.*, out of bankruptcy. *Sartid* steel company operated well below its rated 2.2 million metric ton capacity. The operations had been badly neglected with insufficient investment in the machinery and infrastructure.

The operations and their more than 9,000 workers basically survived on limited state assistance aimed at preventing collapse of the company and the social unrest likely to ensue with the collapse of one of Serbia's largest companies. During the following ten months, *U. S. Steel* managed the operations, paying the monthly costs of employee salaries, raw materials charges, utility and railway bills. The managing agreements prevented the collapse of the company and economic devastation in the region.

The greatest exporters in Serbia 2007



Thus, *U. S. Steel* became one of the leading investors in Serbia. During its first year of ownership, *U. S. Steel Serbia, d.o.o.* has made a series of capital investments including:

- a USD 3.2 million rehabilitation and startup of the K-3 steel producing converter, idle for more than 13 years

- purchase of a USD 2.3 million tension leveler system for enhancing output and quality of tinplate products at the Sabac plant
- a USD 10.5 million project upgrading electronic controls on the Smederevo Plant's cold reduction sheet products line

In September, 2004, the company announced it would invest more than USD 38 million in projects to advance the Smederevo Plant's production to its rated raw steel capability of 2.2 million metric tons. The projects include:

- rebuilding the plant's No. 1 blast furnace, idle since 1987
- improvements in the basic oxygen steel producing shop to enlarge furnace heat sizes from 92 to 112 tons per batch, a 20 percent increase in output
- modernization of the plant's two continuous casting machines with installation of variable width casting molds.

In December 2005 – The Serbian Investment and Export Promotion Agency (SIEPA) named *U.S Steel Serbia* the top exporter of the year. Also, this position is held in 2006 and 2007.

4. Risks

FDI can also bring risks to a host developing country. The literature indicates some cases were FDIs have been the target of criticism for "direct harms"— such as pollution and natural resource degradation. However, no connection was found between environmental index and share of FDIs in GDP, indicating that pollution can emerge both in the presence and absence of FDIs.

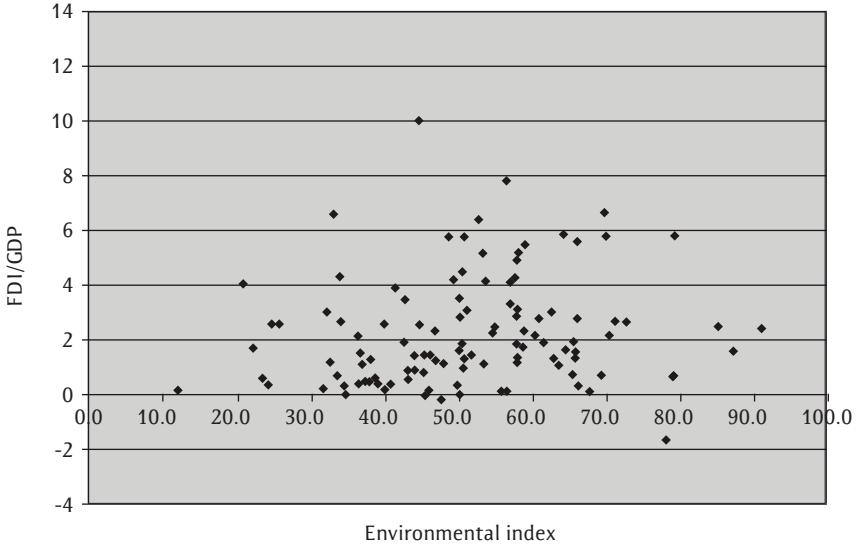
Risks stem from the possibilities that FDI will

- lower, rather than raise, domestic savings and investment, including negative effects to GNP via profit repatriation;
- "crowd out" domestic companies from capital markets;
- increase demands for foreign exchange;
- support local oligopolies and be anticompetitive;
- distort local politics and thwart regulation;
- create instability through increasing financial volatility;

- seek to protect technology rents rather than transfer technology, reducing or eliminating hoped-for spillovers and externalities.

Most studies over the past decade have examined "net assessments" of the impact of FDI covering 183 projects in some 30 countries over the past 15 years and found "a clearly positive impact on the economic welfare of the host". Also, macroeconomic country studies generally have found a positive impact of FDIs. An IMF study found evidence of positive effects, including productivity increases through technology transfer, to be "overwhelming. Several studies indicated that, to capture the benefits of FDI, a country must already have reached some kind of "development threshold". FDI is also proven to raise growth only in countries where the labor force has achieved a minimum level of education (Borensztein et al, 1998).

Figure 7 FDI and the Environment



Chapter III

Spillover effects of Greenfield FDI

1. What are spillover effects?

Direct effects of FDIs, both Greenfield and others are clearly visible. As it was demonstrated in the previous chapter, these effects are substantial in the area of growth of output and value added (contribution to the GDP growth), growth of employment, export and competitiveness growth and technological progress. Since the firms that are established by Greenfield FDIs are capturing these results, investors are in position to capture these results in their increased total revenues, decreased operational costs and, ultimately, increased profit. Accordingly, these effects are direct effects of the Greenfield FDIs. Furthermore, direct effects are the effect to customers of the firms created by the Greenfield FDIs in terms of the new products, both goods and services, better quality-price combination, etc.

But there are some effects that these firms and Greenfield foreign direct investors are not able to capture. These spillover effects of the Greenfield FDIs are those that affect not the firm that was created by the FDI, but other firms in the recipient country and, by that, all the customers, not only customers of the FDI's firm. Since these effects are not able to be captured by the FDI created firm, there are considered as external effects or external economies.

Theory of **external economies** gave a rather straightforward explanation of the existence of such economies. The economic theory specifies that external economies exists in the case of firms exist if the action of one economic agent (firm) affects the productivity and/or costs level of the other (firms) and that this action is not sanctioned by the market, hence no price has been charged/paid for that. Unfortunately, most of the external economies that are considered today in public debate are actually external diseconomies, since one economic agent inflicts additional costs to the other. Typical external diseconomies are associated with pollution, i.e. environmental damage that increases costs of production of all the firms that are affected by that kind of environmental external diseconomies. There are two features of all the external economies and diseconomies, and these can easily be recognized in the case of pollution. First, there is no voluntary exchange between the two sides: the one that creates the pollution and the one that receives the pollution. Otherwise, there would be a market price relate to the exchange. Second, the side who sustain the costs (loses) does not receive the compensation. Now the concept of external economies is clarified.

Nonetheless, apart from external costs, there is a substantial number of external economies, i.e. external benefits to other firms. Usually these benefits are not as visible as external costs, so their media coverage is not so frequent. Typical external benefits can be spotted in any shopping

mall. Customers that come to visit one shop in the mall, have strong incentives to visit the all others. Opening of additional shop in the shopping mall increases the number of people/customers that are visiting all other shops in that mall. The very concept of the shopping mall is based on the external benefits that shops are creating to each other.

Crucial prerequisite for external economy to exist is that firms who are producing benefits to the others are not able to capture these benefits, i.e. to charge a full market price for them. If these benefits/effects are captured, than external economies are internalized: external economies are no more. But if they are not captured, if external economies exist, than the problem is that firms, because they can not capture the benefits, do not have incentives to produce these benefits, or not to produce them in sufficient quantity. That fact clears the way to discuss the possibility for government intervention, i.e. for government producing incentives for producing external benefits that market can not.

2. Spillover effects: a simple taxonomy

In the case of FDIs external economies are usually labeled as "spillover" effects. Again, a crucial prerequisite for some effect to be classified as a spillover effect is that foreign direct investor cannot capture it, and to make it a part of his/her business calculation. These spillover effects are, in general, divided to intra-industry and inter-industry effects. Intra-industry spillover effects, sometime referred to as horizontal spillovers are those spillover effects that are beneficial only to the other firms that are in the same industry, whatever the industry is: telecommunications, banking, cement, etc. Firms in other industries are not affected by these spillovers. The important thing is to properly understand meaning of the word "beneficial". For example, one of the inter-industry spillovers is increasing of competition in the industry by enhancing competitive pressure. Someone can ask a question whether these effects are really beneficial for the competitors. In short term, it is definitely not. As Nobel Prize laureate John Hicks has pointed out "the sweetest of all monopoly profits is quiet life". Hence, private as well as other firms do not like competition. In the long term, however, competition is beneficial even to them, because competition provides incentives for economic efficiency. Most of all, it provides incentives for productive efficiency. In the long run, only competition can provide competitiveness of the firms and competitiveness of the industry. Needless to say, the increased competition between the firms, i.e. producers/suppliers is beneficial to the customers. Hence not only the customers of the products that are produced by the

Greenfield FDIs, but all customers in the industry receives benefits of the increased competition due to, what economists are referring to as new entry, i.e. Greenfield FDIs. The mechanism of both causality links will be explained in details later in this chapter.

Intra-industry spillover effects, i.e. vertical spillovers are these effects to the local firms in the all other industries and customers of their products. There are always direct vertical links between firms created by the Greenfield FDI and local firms: they could be both upstream and downstream. Upstream links means that Greenfield FDI created firm sells its products (good or services) to the local companies, like, for example, dealers/distributors, who then provide these products to the customers/consumers. Downstream links means that local companies are providing inputs to the FDI created firm. Spillover effects are not these that are captured by the FDI created company, but those captured by local companies and, eventually, transferred to all the customers. Upstream and downstream links underlines direct vertical contacts between FDI created firm and local firms as the background for spillover effects. Nonetheless, in some case there is no need for direct contact (being them horizontal or vertical) between these firms for spillover effects to take place. For example, FDI created firm can train an employee in their best business practice manner in some area that is common for all companies, irrespectively of the industry, like, for example, accounting. If that employee leaves his/her Greenfield FDI created job and gets another job in some other, completely unrelated local firm, that firms will, free of charge, gain his improved accounting skills. Of course, local firms pay these specialist market salary; nonetheless, local firm does not bear costs of the training of these specialists, i.e. they do not invest in creating in their human capital.

3. Mechanism of spillover effects

The first spillover effect that is completely intra-industrial is increasing of **competition**: the more competition, the better. That statement is valid for almost everyone. It is definitely better to have more competition from the viewpoint of customers, and it is better for everyone else except idle, indolent and slack employees' and producers/firms: they do not like competition and usual find very imaginative explanations why competition is not good for a society.

Many people wrongly consider that number of competitors in the industry is the only indicator of the level of the competition in that industry. That is simply not true, though number of competitors is not entirely irrelevant. Competition is, according to the Nobel Prize

laureate George Stigler, predominantly rivalry between competitors, i.e. competitive pressure to one firm from all other firms in the industry. That rivalry/pressure provides incentives to every firm in the industry for economic efficiency: the only way for every firm to survive is to be efficient. The most important feature of economic efficiency in this case is so called productive efficiency that includes a several elements: development of new, better products, new ways to serve customers and decreasing costs and lower prices. The advent of Greenfield FDI based firms brings new competitive pressure in the industry: because of the well developed new products, improved ways to serve the customers and their costs efficiency, that is embodied in their lower prices. These features of the FDI based firms are due to their superior technology, as well as superior know-how based in their international background, already tested in many other countries of operations and adopted as the best practice. Accordingly, Greenfield FDI based firms brings on superior production process and by that substantialy increases competitive pressures to the local firms in their industry. That advent is far more that another local competitor, this is a competitor that makes a substantial impact to the incumbent firms, increasing competitive pressure. Sometimes this view is restricted to the idea that these new entries will break–up monopoly in some industry by introducing a few firms. It is far more that, because competition is about rivalry, not the number of competitors, and with the advent of the Greenfield FDIs, that pressures is based on modern technology, state-of-art know-how and worldwide tested best practice.

Box 1
Measuring the competition

It is difficulty to measure competition, but some proxies can be used for that. One of the proxies is advertisement expenditures. The stiffer competition, the more advertisement expenditures. With the advent of *Vip mobile* in 2007 all mobile operators has increased advertising budgets several times in comparison with the previous year. The two incumbent mobile operators were ranked below 20th position in terms of advertisement expenditures and in 2007 now they are among 5 top companies according to the advertisement expenditures

The other channel of competitive pressure that is created is a potential entry of the Greenfield FDI's. If government policy is the one with low barrier to entry, particularly low legal barriers to entry, all incumbent firms are disciplined by a threat of potential, new entry of some Greenfield FDI. The best way to demonstrate that threat is that some FDIs Greenfield already have materialized in the recipient country in a given industry. The best proof that something is possible is that it already exists. Accordingly, it is not only the competitive pressure of existing FDI based Greenfield, but also new entries of that kind that proved to be feasible by these that already entered the market.

The other mechanism in which Greenfield FDIs increases is that they produce a new yardstick for other forms to measure their business operations. The point is that if local firms compete with each other or local monopoly exists and none of the firms have information about attainable/feasible costs. Even if they have the best incentives for decreasing the operational costs to increase the profit, they do not have an appropriate information whether they are successful in their drive for costs cutting. This information function of the new entry is very important in the world of asymmetrical information. New entry of the Greenfield FDI provides a yardstick, or a benchmark for all local competitors and helps them, irrespectively of other mechanism of competitive pressure, to reduce their costs and to increase economic efficiency of production.

Increased competition brought about by Greenfield FDIs produces substantial beneficial effects to all the customers of the considered industry. That competition brings about: new products, innovative ways to serve the customer, new marketing, and lower prices for the customers. In case of banking for example, such a Greenfield FDI induced competition brings about new types of loans (fast cash credits, for example), innovative and better ways of communication with customers in the process of extending this loan, new ways of marketing communication in which customers are informed about all relevant details regarding the product and can make their own rational choice about this product and its use, and finally due to increased competition and reduced costs, interest rates that customers are paying are going down (for a given risk of the loan). If the customers are not consumers, but producers, than these effects are multiplied, because increased competition due to the FDIs Greenfield investments enhances operations of other producers and could be beneficial for consumers of their products. For example, reduced tariff rates for mobile communications and increased quality of that communications have beneficial effects for both consumers and producers that are using these services as their production input. At the end of the day, consumers are, both directly and indirectly, reaping the benefits of increased competition.

It is estimated (Deloitte, 2008) that the new entries to the Serbian mobile telecommunication market (*Telenor* in 2006 and *Vip mobile* in 2007) made all Serbian customers (both commercial and residential) to benefit from a significant increase and diversification in the service offer and a fall in prices for 14%. Furthermore, the same report provides an estimate that the business usage of mobile telecommunication contributed to the increase in productivity of an individual worker by 7% in 2007. Modern ICT is indispensable for economic growth in era of modern, new economies. Increase competition due to new FDIs' entries inevitably leads to the increased penetration rate. Competition of three mobile operators in Serbia produced penetration rate of about 90% of the population, standing at an estimated 72% when multiple SIM cards are accounted for (Deloitte, 2008). Such a penetration significantly decreases transaction costs of virtually any transaction, irrespective on which market. For a country with huge unemployment, it is crucial that better communications significantly reduces transaction costs at the labor market, increasing probability of new employment. Huge penetration rate of mobile communications made possible complete replacement of the cash payments for car parking in Serbian cities – widout widespread use of mobile communications, such a system is not effective. And all these contributions are due to the spillover effects due to increased competition between operators in mobile telecommunications industry.

Imitation is very important channel of horizontal spillover effects – it is usually labeled as "classical" transmission mechanism for new products and processes. Apart from that, the same channel is a transmission mechanism for managerial/organizational innovations. In the case of new products imitation is based on "reverse engineering" and its success depends on product complexity – it is easier to imitate simple products. The problem of complexity in reverse engineering in the case of service industries is not so relevant, i.e. it is not as big obstacle as in the case of managerial/organizational innovations, which are much more transparent than patent protected innovative products/technologies. As these innovations like new tariff structure (see Box 2) and customer relations innovations are quite transparent to customers, they are also transparent to the local firms in the same industry, i.e. local competitors. The level of transparency increases for products to services, hence imitation is very important in various services (telecommunications, retailing banking, insurance and other financial services, transportation etc.). Hence, in service industries imitation is one of the most important channels for intra-industry spillovers.

Box 2
24/7 dissemination

Vip mobile as a Greenfield FDI in mobile telecommunications was the first to offer a new tariff package on the Serbian market: flat prepaid tariff for calls and SMSs to all networks 24 hours a day, seven days a week (24/7). That package was offered before *Vip mobile* started its operation. It is, no doubt, simple and most transparent tariff package offer that has not been offered at the Serbian market before. Two incumbent operators started the implementation of exactly the same tariff in mid May 2007, several days before *Vip mobile* started the operation.

FDI's create very specific demand for inputs and in that way affects their local suppliers. In that sense **vertical downstream links** are basic channel for this type of vertical spillover effects (inter-industry spillovers). FDI's in general and Greenfield FDIs specifically creates very specific demand, usually by much higher standards in terms of the quality of the inputs (requested materials, goods and services), quality of the services that are offered to the customer in terms, for example, of precise timing (just in time) of delivery, zero tolerance for contact breaching regarding the delivery, etc. These standards are usually much higher than the standards of local companies and that their requests to the local supplies. In other words, FDIs mean stiffening competition and competitive pressure on the local input markets with new demand requirements and pretty clear directions for all suppliers that would like to be successful. That creates incentives for local supplier to invest in increasing quality of their output and to restructure their operations to increase the quality of their services to the all customers, not only to the Greenfield FDI's customers. Furthermore, Greenfield FDI usually provide some support to these suppliers in their efforts to meet these standards in terms of training, technical assistance, know-how transfer etc. In that sense, benefits of the restructuring and improved operation of local suppliers are disseminated to all other customers. When a local firm learns and starts to implement new standards of, say, production and delivery its products, these standards are enforced indiscriminately, irrespective of the customers. This kind of vertical spillover effects have impact on all the customers of the industry that is supplying Greenfield FDIs. The other customers are free riding on the efforts of the Greenfield FDIs to increase the standards of supplying inputs.

Box 3
Vertical downstream/upstream links

All three Greenfield FDIs in Serbia that were analyzed demonstrated very strong vertical downstream linkages with local firms. *Vip mobile* is purchasing construction works (masts for antennas) from domestic construction companies in the modern way that these companies are not used to. The same goes to the software that is purchased from the local software developers, i.e. local forms are used for developing these parts of the software that are specific for Serbian market. *Raiffeisen bank* developed long term relations with local software producers for developing specific banking software.

As to the upstream links, *Ball Packaging* transportation/distribution is completely contracted-out to local trucking industry. Loading of the product is completely regulated according to the Ball Packaging standards and each truck operator is obliged to purchase a GDP device that enables Ball Packaging to track down each shipment and its status in real time. Distribution/retailing of the *Vip mobile* services is contracted-out to local firms. These firms and their employees received the training from *Vip mobile* in terms of the know-how that is standardized on the corporate level. The new corporate standard improved the performance of the local distributors/vendors.

The same mechanisms of vertical spillovers exist in the case of **vertical upstream links**. Again increased competition, increased standards, followed by in terms of training, technical assistance, know-how transfer etc. In the case of telecom industry, the retailing of the telecom services is completely outsourced from the telecom operator to the local distributors/retailers. In the case of manufacturing of, for example, aluminum canes for beverages, which are supplied to the beverages' producers, transportation and delivery of the products, are completely outsourced to local trucking industry. Modern economy is about outsourcing and focusing to the core business. That is exactly how companies built on Greenfield FDIs operate. Apart from purchasing inputs in terms of components and materials on the local market, they are outsourcing various services, like maintenance, security, transportation, advertising, IT services, accounting etc. Many of these services are outsourced to local companies and through this outsourcing vertical spillovers are created.

Empirical studies provided evidence that in some countries vertical spillovers are the most import group of spillover effects. In case of, for example, Lithuania (Javorcik, 2004) demon-

strated that downstream vertical spillovers are the most important way in which FDIs affects local firms. It is considered that Lithuania is not specific regarding that. That is why it is demonstrated that FDIs in natural resources sector or primary sectors are not so beneficial for domestic economy (Aykut and Sayek, 2007). Naturally, the possibilities for downstream vertical spillovers are very limited in these cases as the market for inputs to such firms is rather limited.

Specific imitation based spillover effects is **export spillovers**. Basically, local firms can learn to export from the FDIs. The important point is that export generally involves fixed costs in terms of establishing distributional networks in specific country, creating transport operations capable of reaching another country, learning about consumers' tastes in that country, specific regulatory arrangements, customs clearing operations (both in the country of origin and county of destination) etc. FDIs based firms have relevant knowledge about all these things as they are experienced in foreign trade and have well developed distributions networks and strategies. They use that experience and network to export for the new recipient country. Local firms can collaborate in these business ventures and acquire knowledge and experience that can after use for they own independent operations. This is a combination of collaboration and imitation. Collaboration is typical vertical spillover effect in the case of export. As already discussed in previous paragraphs, increased standards of demand for the inputs provides incentives for the local producers to adjust their operations to these standards and enables them to be competitive by these standards. These standards are basically international standards. If you supply and FDI based company in your country, than it is not a problem for your local company to supply company in the country of origin of that or any other FDI. That is the way how collaboration with the FDI based companies enables local firms to become exporters.

Imitation of the operations of FDI based companies is more likely to be the method of enabling local companies from the same industry to become exporters. Competition with the FDI based company will provide incentives to improve the quality of the products and to go through all the barriers for foreign trade (export) and some of the information about export channels of the FDI based companies will inevitably be disclosed. Nonetheless, it is much more probable that collaboration, i.e. vertical spillovers will be the mechanism which will enable local companies to become exporters.

The other important channel of intra-industry spillover effects are **investment in human capital**. New technology, new products and processes, as well as superior know-how and managerial/organizational innovations brought by Greenfield FDIs can be effective and can results in high rate of returns only if there are substantial investments in human capital, i.e.

training of local labor force. Crucial decision whether to invest in one country or not depends on the local labor force and local labor market – whether labor force can be obtained at competitive, reasonable price (wages). Nonetheless, hiring local labor force is just a first step for getting all the things right. That labor force should be trained according to the requimen4ts of the FDI, i.e. international operator that invested in a country. That means training in all contemporary state-of-art know-how, managerial/organizational innovations and modern standard, specific procedures division of labor within the firm, and discipline and working habits that are usually stricter that in local firms. Seminars and training courses are arranged in the local/recipient country, but also in the country of the FDI origin and/or some of its international training centers. All these procedures increases human capital of the employees of the Greenfield FDIs – they are inevitable from the point of view of the investors, because only in that way the investor can use superior technology/know-how to get high rates of returns and pay back the investment sooner.

Box 4
Investments in human capital

Continuous training of the employees is one of the most distinguished activities of the Greenfield FDIs in Serbia. *Raiffeisen bank* provides day-by-day training and training for managers on management seminars that are hold on the regional level (SEE). These seminars are also opportunity for exchange experience and regional best practices. *Ball Packaging* provides extensive training according to the standards of the company that are applied on all countries of their operations. This training encompasses such advance procedures like paperless administration, including paperless audit, a procedure that is great innovation by any standard. *Ball Packaging* training includes dissemination of the specific corporate ethics, and corporate culture and discipline. For example, there is an emphasis on the personal safety issues. *Vip mobile* provides three general category of training: expert knowledge, soft skills and exchange of best practice and know-how within *mobilkom austria group*. In the early stage *mobilkom austria group* provided the Greenfield with the group of over 40 experts who developed all company functions with local teams. That was the first stage of training, a specific learning-by-doing operation. Again, training includes development of specific corporate culture and training events are organized in various locations in Serbia for disseminating and sharing these basic corporate values.

Nonetheless, the fluctuation of labor is something that is normal to all modern societies. The fact that one firm invested in human capital does not preclude the employees to leave that firm. For Greenfield FDI's firm it is impossible to lock-in its human resources completely. It can be done temporarily, by provision of minimal stay within the firms, but even that is more difficult with modern labor legislation, more in line with human rights approach. Accordingly, well trained employee can leave the FDI's firm and reallocate his labor resources to the other firms. Who are the mostly likely candidates, in terms of the firms these employees can move to? Naturally, the mostly likely candidates are the other, mainly local companies from the same industry, i.e. competitors that are obtaining fully trained personal with the level of training above the one they have provided to their employees. That is perhaps the most important spillover effect – the returns to the human capital are disproportional to the investments in that very human capital.

Spillover effects due to described investments in human capital need not to be horizontal, i.e. they are not only intra-industry. Many of these investments are more or less general, and are not specific to some industry, but to general business operations. For example, training of accountants in modern accounting standards by the Greenfield FDI's firm produces human capital that can be used in almost all other industries. This is particularly case in some specific types of these investments like financial services in which it is easy to switch from one financial industry like banking to the other financial industry like insurance. There is no need for any business link between the FDI firm and the firms that are enjoying spillover effects due to training of the labor force – the link is established via labor market.

All of the mentioned spillovers that are spillovers to the local firms are, at the end of the day, spillovers to the local consumers, i.e. consumers of the recipient country. Due to the mentioned mechanism/channels of the spillovers to the firms, consumers are facing new products, more option to choose among, new and better ways to service them and their needs. Their needs are better services, among other things, throughout better marketing, better pricing policy and innovation in customers' relations. As already described, new standards of serving the customers are introduced and it is followed by the local firms. Important segment of these standards can be completely new and much more affordable pricing policies and tariff rates that are enforced.

Furthermore, innovative ways to serve customers that are brought by Greenfield FDI makes the consumers in better position to articulate their needs and preferences. Accordingly, consumers' welfare can be improved also in this way, as their communication with the supply side firms, i.e. producers and vendors is improved. Customers in the business sector can also

gain from the business interactions with FDIs as these relations are channeled through new, state-of-art business procedures.

Box 5
Financial reporting

New products developed by *Raiffeisen bank*, a Greenfield FDI, provided not only new opportunities to the local business community, but also new challenges to them. As the probability for approving and extending new loans to the local firms depends on the quality of their financial reporting and the track record of its financial discipline, they have all the incentives to improve both. As to the first one, local firms started to voluntary submit their financial report to external audit, and to make financial reports more reliable. As to the second one, local firms are now aware that breaching financial discipline will have negative effects on the long run, so they have incentives not to breach it. In short, both financial reporting format and substance have improved. And it is not only a Greenfield FDI in banking that benefits from such an improvement. There are free riders like the Tax administration, other banks, business partners of the local firms, etc.

There are **informational spillovers** of the FDIs and they are specific to the Greenfield and other FDIs. The very fact that one investor decides to invest in some country, at some location and in some specific industry provides information to all other that such investment is not only feasible, but also profitable. The bigger investment, and the more prominent investor, the stronger is the signal, i.e. the bigger is probability that additional foreign direct investor will decide to invest in that very country, region and industry. That will affect not only foreign investors, but also domestic investors. The point is that the when reluctant domestic investors realize that foreigners are investing in his/her country, that will increase probability for domestic investor to invest locally, instead of alternatives like long term-savings (generating fixed rate earnings) or investing abroad. Empirical research based on the data for 60 developing countries (Mody and Murshid, 2005) provided evidence on string "crowding-in" effect, i.e. evidence that increased FDIs produced increased domestic investments. Informational spillovers, though not only them, produce clusters, i.e. groups of the firms from the same industry involved in the similar products.

Finally, there is no doubts that **public policies**, particularly economic policies, and reform of these policies influences the level of FDI (more detailed analysis of specific policy reforms that attracts FDIs follows in the next chapter). Furthermore, institutional reform and institution building is also very important for attracting FDIs. It was demonstrated in a number of recent contributions, both theoretical and empirical (for example, Campos and Kinoshita, 2008) that liberalization of foreign trade, financial liberalization and privatization increases the relative level (relative to the GDP) of the FDIs. Furthermore, institutional reform and institutional development that increases, for example, the quality of bureaucracy and constrains to the executive branch and rule of law indicators and decreases, for example, corruption and political risk, increases the relative level of FDIs. These findings became a kind of common place and conventional wisdom. They are not only restricted to the academic circles and very technical papers published in academic journals. Policy makers in many, almost all countries are aware of these regularities and, because attracting FDIs for many countries is the only way to establish sustainable economic growth, they pursue or at least under a political pressure to pursue these public policies and specific institutional reform. Accordingly, there are spillover effects to the local firms, because the mentioned public policies and institutional developments have beneficial effects to local firms as well as to the FDIs.

Increased level of FDIs proved to have substantial beneficial effects not only on economic, but also to some other public policies. They provide impetus for more benevolent foreign policy of both recipient country and country of origin. Both governments have very good reasons to maintain good diplomatic relations and even to improve them, because they are somewhat "hostages" of the FDIs that already materialized and that are expected by business community and consumers of both countries. Accordingly, FDIs have beneficial spillover effects to political integration of the countries. Most of the FDIs today materialize among the countries that are politically integrated like countries of the Euro-Atlantic political integration.

4. Magnitude and measurement of spillover effects

If spillover effects are too small, FDIs are not beneficial after all apart from the direct effects. Nonetheless, the crucial problem is that spillover effects should not be too small, but also not too big. If the spillover effects are too big, that means that the investors are not able to capture the majority of the benefits they are creating, which means that their returns are modest. In

very competitive world of the FDIs, investors compare rates of returns in different countries and make their investment decisions on the base of that rate. Huge spillovers make rates lower, hence the probability for investments to materialize in such conditions is decreasing. If the spillovers are too small, its is only the FDIs sector of the economy that is generating growth and a substantial division exists between two sectors in the economy: one of the FDIs, modern sector well integrated in the international economy and the other is the sector of local firms, sluggish and not integrated to the international economy. Not too small and not to big: the best balance of the spillover effects.

Furthermore, there is another important question regarding the magnitude of these effects. The rationale for providing government intervention incentives for FDIs is spillovers. One should recollect that the very ground of spillover effects is that there are external economies, i.e. that investors are not able to capture them in their returns. Exactly because of that, some people and decision-makers think that FDIs should be effectively subsidized through, for example, tax holidays, or even explicit subsidized, measured as government grants to the investors, based on for example number of jobs that are created. *Prima facie* it could seem reasonable to some people. But the crucial precondition for that operation to be reasonable is that the amount of the subsidies is not bigger than the amount of created spillover effects. That creates enormous methodological problem of measuring spillover effects, like measuring any kind of external economies.

There have been a few efforts to econometrically measure spillover effects for different countries, regions and time periods. All of them have faced insurmountable methodological problem of measurement and other econometric problems. Testing to what extend FDIs influence economic growth in the countries of Central Europe Mencinger (2003) found evidence that there are no spillover effects, but that finding is based on numerous rather crude methodological errors. The similar finding for the same groups of countries has been reinforced (Damijan *et al.*, 2003), but with similar methodological problems. Two most important contributions in the area (Schoors and Van der Tol, 2005 and Castellani and Zanfei, 2006) demonstrated that specific methodological error created bias downwards in the estimated of the spillover effects. Both contributions found empirical evidence that spillover effects are significant. Nonetheless, it is impossible to measure precisely spillover effects and to disclose them in monetary terms.

That is one of the crucial reasons why FDIs should not be subsidized. If the government does not know what is the amount of the benefit, than the government can not specify the amount of the subsidy. Another reason why active measures for attracting FDIs like subsidies are not

recommendable would be due to the special interest politics and public choice procedures that can lead towards that private interest capture the state. It is always much better to improve the public policy and institutional framework that equally affect all the players (investors) and to have leveled playing filed that to have highly focused support, as it will have winners and losers. Winner have incentive to influence the process and transparency is then lost.

5. Preconditions of the spillover effects

Much more important issue is the one about the absorptive capacity of the recipient country, i.e. absorptive capacity of the local firms. The point whether local firms will benefit from the FDIs depends on their relative backwardness and their absorptive capacity for assimilating knowledge and innovations. That capacity depends on the complexity of the technology and know-how that is transferred trough FDIs and the technology/know-how gap between local firms and the Greenfield FDIs' based firms. There was enough evidence in empirical research to support this main finding. The bottom line is that local firms can benefit only if the technological/know-how is not too wide, so local/domestic firms can absorb the knowledge available from the Greenfield FDIs. The problem is, however, the measuring the size of the technology gap. What is the threshold, i.e. a technological gap that provides to be a barrier for the spillover effects? It is not disputable that on the recipient side, local firms must have some absorption capacity, but it is still very difficult to say what is the exact necessary level for spillovers to be accepted, i.e. to materialize. Furthermore, for the time being, dynamic factor is not taken into account.

It is evident that different absorption capacity means different levels of spillover effects. If the local firms are divided to exporters and non-exporters, that could be a proxy for their absorptive capacity. Empirical research done in Spain (Barrios and Strobel, 2002) demonstrated that spillover effects in the case of exporters and much more intensive than in the case of non-exporters as their absorptive capacity is lower. Furthermore, local firms can be distinguished whether they are R&D intensive, and that can be a proxy for their absorptive capacity. Empirical research done on Czech Republic (Kinoshita, 2001) provided evidence that there were positive spillover effects in the case of the firms that are R&D intensive. In other words, absorption capacity matters.

As to the absorption capacity, it is now evident the attention should not be focused only to local firms and their capabilities as such. A part of overall absorption capacity of the recipient country is based on the features of the local labor force, predominantly its capacity to learn and

to learn fast local labor and the flexibility of the local labor market, for example, how frequent is turnover in terms of employed labor. That will trigger perhaps the most important channel of spillover effects: the one based in the investment in human capital.

Box 6
Myths and realities about Serbian labor force

Labor in Serbian is not a cheap resource. Labor costs of firms that operate in Serbia are not low. Hence this is not something that attracts FDI to Serbia. It is the flexibility of the labor force and its ability to learn fast. Some background education helps. What is important is that labor force in Serbia has it own quality, dynamism and it is highly motivated and very adaptable – it can adapt to new business principles and culture. Locally trained engineers are considered as the best offspring of Serbian education system. Furthermore, Serbian labor force is rather loyal to the employer and the turnout of the labor is much smaller than in some EE countries. Absenteeism is not big. In the case of *Ball Packaging* FDI the absenteeism in Serbia is lower compared with their facility in the UK.

Empirical research (Mody, 2004) demonstrated that the education of the local labor force, measures by the years of schooling, significantly contributes to the absorption capacity of the country and the magnitude of spillover effects. Apart from the local labor force, empirical evidence was found that local infrastructure and financial market development are crucial factors of the absorption capacity of the country (Kinoshita and Liu, 2007).

6. Conclusion

The is no doubt that spillover effects of the FDIs, particularly of the Greenfield FDIs are substantial and important for economic growth and welfare of recipient's country society. It was demonstrated that these effects are versatile and that they have impact on both producers (in the some and in the other industries) and consumers. At the end of the day there is a beneficial impact to consumers. Spillover effects are particularly important in the case of some industries,

like modern telecommunications and banking industry, as they have become a kind of a prerequisite for modern economic growth, a growth of the new economy.

There are two very important finding regarding the recipient country. The first one is that it proved impossible to measure precisely spillover effects and to disclose then in monetary terms. Methodological obstacles to that proved to be too high. Taking that into account it should be recommended that a country should not subsidize the FDIs. Some people find rationale for such subsidies in the very fact that investors are not capturing spillover effects they are producing, so they should be compensated for that. Without precise measurement such compensation is not feasible. Let alone the damage that it can make as the private interest capture the state.

The second finding is that the scale and scope of spillover effects heavily depends on the recipient country, predominantly local firms and their absorptive capacity. It is of the crucial importance that the gap between foreign direct investors and local firms in not too big, otherwise, the spillover effects will be negligible. It is the labor force of the country which is crucial for the absorptive capacity. The more flexible labor market and better education, the better labor force propensity toward greater absorptive capacity.

Chapter IV

FDI business environment

1. FDI Determinants

The decisions on locations of investments are usually based on thorough detailed calculations. The nature of this decision-making process has not been thoroughly analyzed, but there were some surveys of multinational companies that shed some light on this issue (Delloite and Touche 2001).

One thing which is clear is that FDIs are in principle a very heterogeneous group. Various investment motives determine the importance of different investment factors. For example, resource-seeking investments have relatively short list of demands – easy access to the resource, infrastructure of adequate quality and tolerable levels of corruption and environmental regulation. On the other side, market-seeking investors look for large economies with strong consumer purchasing power, countries with expected growth in living standards and countries which are members of regional free trading areas. Efficiency-seeking investors look for countries in which low wages will not be swamped by unproductive workers, inadequate infrastructure, intrusive and inconsistent regulation and pervasive corruption.

It is clear that different objectives, needs and strategies have caused companies to design different mechanisms for evaluating investment location. However, there are certain criteria which consistently show up in the research: access to consumers, stable social and political environment, ease of doing business, reliability and quality of physical infrastructure, ability to hire technical professionals, ability to hire management staff, level of corruption, cost of labor, crime and safety, corporate tax rates, cost of utilities, etc.

UNCTAD's 1998 Report classifies determinants of the FDIs in three distinct groups: policy framework, economic determinants and business facilitation.

According to UNCTAD, policy framework consists of all the business regulations that the government introduces in order to regulate business activities, such as tax policy, privatization policy, regulations regarding business entry, construction, labor relations etc. Economic determinants are usually exogenous factors (at least in the short run), such as market share, consumer preferences, geographical position of the market, natural resources etc. UNCTAD also identifies a group of factors, called "business facilitation", which include some public policies, such as financial incentives for investments, but also a host of other factors, such as existence of bilingual schools, corruption and such.

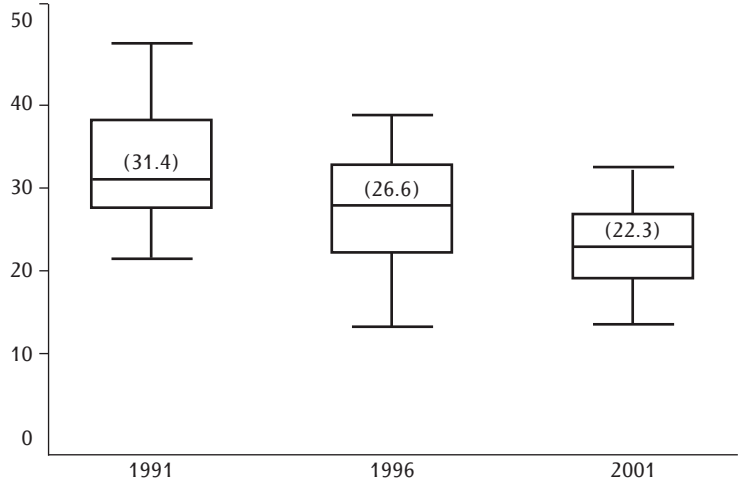
Our focus in this chapter shall primarily to the first group of determinants (policy framework, business climate, business environment) with a limited insight into two other groups of determinants.

The key determinant of the FDI inflows to a certain country, which is under the direct government influence, is the business climate (business environment). Business climate consists of all public policies that affect the business operations, such as tax policy, trade policy, labor policy, zoning and construction policy etc.

Taking into account the increased international mobility of capital in the previous years and the expectation that these trends will continue, the governments have realized that in order to attract foreign investments (especially export-oriented ones), thorough reforms in the area of business environment are needed. Some critics see this deregulation movement as "race to the bottom", but in reality most of the regulations are serving some special interest and their removal usually does not have a large negative impact on general public.

The following graph demonstrates the trend of reduction in effective marginal corporate tax rates in OECD countries (Hajkova *et al.*), which is an indicator of improved business climate.

Figure 1 Reduction in Marginal Corporate Tax Rates



The same paper concludes that FDI's are very sensitive to corporate taxes and that one percent increase in marginal corporate tax rate leads to a 2% to 4.5% reduction in the FDI stock in the country.

Besides taxation, other government policies also have a direct effect on the FDI inflow. For example, Yavorcik and Sparteanu (2005) demonstrate that "the FDI location choice as well as the volume of FDI is positively related to labor market flexibility in the host country and to the difference between labor market regulations in the host and the source country. That is, a more flexible labor market in the host economy (relative to the investor's home country) is associated with a higher likelihood of investment. As expected, this effect matters more for firms operating in services sectors than for manufacturing companies."

These and other academic papers stress the importance of reasonable business regulations and demonstrate their impact on FDI inflows.

But, besides direct business regulations, other government policies also influence investor decision. One of the key government activities, of importance for FDI, is protection of private property and proper administration of justice.

Namely, investors always take into account the probability that their property and revenue might be stolen by predators or expropriated by the government. The lower this probability is, the higher the estimated rate of return is and the higher the probability that investment shall occur.

2. Components of the Business Environment

The concept of business environment is very fluid. The components of the business environment are many, but one of the best international comparisons regarding the business environment is the "Doing Business" report series prepared by the World Bank.

Namely, this report provides measures of business regulations and their enforcement across 178 countries in the world. The report covers ten main areas: Starting a business; Dealing with licenses; Employing workers; Registering property; Getting credit; Protecting investors; Paying taxes; Trading across borders; Enforcing contracts; Closing a business.

All of these factors (excluding perhaps "Getting Credit" to a certain extend) are very relevant for foreign investors making decision on where to invest.

Starting a business is related to the ease of opening a new company and registering it with the government. The data on starting a business are based on a survey and research investigating the procedures that a standard small to medium-size company needs to complete to start operations legally. These include obtaining all necessary permits and licenses and completing all required inscriptions, verifications and notifications with authorities to enable the company to formally operate.

Dealing with licenses is probably the most relevant factor for Greenfield investments as it is primarily related to the land development, i.e. building licenses and permissions – it deals with non-specific licenses needed for developing a plot of land a constructing a typological business outlet, a rather small warehouse. This includes all town-planning licences, development permits, infrastructures/utilities compliance licenses, public health, fire protection and that kind of permits. Specific licenses, i.e. for operations in specific industries, like mobile telecommunications, banking, finance etc. are not taken into accent in the case of "dealing with licenses". In many countries, especially poor ones, complying with building codes and regulations is so costly in time and money that many developers/investors opt out. Investors may pay bribes to pass inspections or simply build illegally—leading to hazardous construction. In other countries compliance is simple, straightforward and inexpensive—yielding better results.

As already mentioned, investors usually prefer a more *flexible labor market*. Almost every economy has established a complex system of laws and institutions intended to protect workers and guarantee a minimum standard of living for its population. This system encompasses four bodies of law: employment, industrial relations, social security and occupational health and safety laws. Doing Business Report examines government regulation in the area of employment and social security laws.

Registering property is also very important for any investor, since unregistered property faces higher risk of being stolen and/or expropriated. Simply, investors want to have an easy way of registering the property and of having a way to prove the legitimacy of their ownership. In addition, clear property ownership allows leveraging the property and securing financing.

Protecting investors is another measure developed in the Doing Business Report of importance for deciding on FDI location. The idea behind this indicator is to assess the protection that (usually) minority shareholders have against company managers. If the property rights of investors are not protected, majority ownership in a business is the only way to eliminate chances of expropriation by managers. But then investors must devote more oversight attention to fewer investments. The result: entrepreneurship is suppressed, and fewer profitable investment projects are

undertaken. However, this specific case is not very important for the type of FDI's that we are looking at, since most of FDI and Greenfield investment cases involve having a majority stake at the company.

Paying taxes is another indicator. This indicator does not just include the tax rates and levels, but also the complexness and amount of red tape related to the tax collection. Poor countries tend to use businesses as a main collection point for taxes. Rich countries tend to have lower tax rates and less complex tax systems. And rich countries get more from their taxes. Simple, moderate taxes and fast, cheap administration mean less hassle for businesses—and also more revenue collected and better public services. More burdensome tax regimes create a strong incentive to evade taxes.

Trading across borders is one of the key activities in the daily operations of basically any foreign investor. Most foreign-owned companies import a lot and export a lot. Countries that have efficient customs, good transport networks and fewer document requirements – making compliance with export and import procedures faster and cheaper – are more competitive. That leads to more exports - and exports are associated with faster growth and more jobs. Additionally, a need to file many documents is associated with more corruption in the customs and state administration.

As already mentioned, protection of private property and *enforcement of contracts* is usually very high on the investors check list. Businesses that have little or no access to efficient courts must rely on other mechanisms, both formal and informal – such as trade associations, social networks, credit bureaus or private information channels – to decide whom to do business with and under what conditions. Across countries, the more procedures it takes to enforce a contract, the longer the delays and the higher the cost.

Closing business procedures also tend to be very cumbersome. Bottlenecks in bankruptcy cut into the amount claimants can recover. In countries where bankruptcy is used, this is a strong deterrent to investment. Access to credit shrinks, and nonperforming loans and financial risk grow because creditors cannot recover overdue loans. Conversely, efficient bankruptcy laws can encourage entrepreneurs. The freedom to fail, and to do so through an efficient process, puts people and capital to their most effective use. The result is more productive businesses and more jobs.

3. Serbia

Serbia has seen a big progress in the past several years on the business climate front. However, many obstacles remain.

The Strategy for Foreign Direct Investments, adopted by the Serbian Government, stresses that there are four main groups of obstacles for FDI's in Serbia:

1. Legislative problems
   a) Urban land ownership and other land-related problems
   b) Need for substantial improvement and modernization of court system
   c) The need for a more comprehensive legislative changes
   d) Reform of the construction-related (land development) legislation
   e) The system of land use fees and charges undermines Serbian competitiveness and creates insecure environment
2. Limited institutional capacities for the implementation of reforms and for strategic planning and marketing
   a) The need to make all investment-related issues a priority for all state institutions
   b) The need to give a priority ranking to the capacity building for investment promotion, strategic planning and policy development
   c) Improve the administration of construction/development permits by developing One -Stop-Shop principle
   d) The need to support private sector and educational system in overall reform process
3. Late start of reforms, inadequate infrastructure and limited access to measures to improve competitiveness
   a) The need to accelerate economic reforms process, introduction of modern regulatory framework and privatization of large state owned companies
   b) The need to develop industrial and technology parks
   c) The need to improve access and reduce administration costs of accreditation, quality control, certification and access to other international standards.
4. The need for a better understanding of the importance of FDI's and development of programs sensitive to the investor needs and a well-targeted national investment promotion program.

Basically, one can conclude that the government is fully aware of the importance of the business environment for the inflow of FDI's. The strategy does stress almost all of the key issues faced by Serbia and identified by the investors as important – land ownership, costs of administration, privatization of state-owned companies. Also, the strategy is followed by a rather well-developed Action plan.

Doing Business Report provides a similar assessment. As can be seen from the following table, the main problems in Serbia are linked to dealing with non-specific land-development licenses,[1] paying taxes, court related issues (registering property, enforcing contracts) and employing workers (labor market flexibility).

Table 1 Doing Business 2008: Ranking of Serbia

Category	Doing Business 2008
Ease of Doing Business	86
Starting a Business	90
Dealing with Licenses	149
Employing Workers	110
Registering Property	115
Getting Credit	13
Protecting Workers	64
Paying Taxes	121
Trading Across Borders	58
Enforcing Contracts	101
Closing a Business	103

1 As it has already been emphasized, dealing with licenses does not include specific licenses needed for operations in specific industries like telecommunications, banking, finances etc.

Starting a Business

Starting a business in Serbia is still relatively difficult and costly. Although significant reforms in this area have been implemented with the creation of the new Business Registration Agency, Serbia is still ranked as 90th in the world.

Doing Business report documents that starting a business includes 11 different steps, which take 23 days and cost 12% of GDP per capita. Detailed analysis shows that Business Registration Agency is relatively efficient, but that other actors in this process (notably Tax Administration) are relatively inefficient. For example, it takes 11 days to obtain Tax Identification Number (PIB) and to register with the Tax Administration.

Table 2 Starting a Business: a Regional View

Country	Procedures (number)	Duration(days)	Cost (% of GNI per capita)
Bosnia and Herzegovina	12	54	30.1
Bulgaria	9	32	8.4
Croatia	8	40	11.7
Hungary	6	16	17.7
Macedonia, FYR	9	15	6.6
Montenegro	15	24	6.2
Serbia	**11**	**23**	**11.9**

As can be seen from the table, Serbia has more required procedures, but the duration is below regional average.

Land Issues

The most important obstacle in Serbia for FDI's in general and Greenfield investments in particular is acquiring the land and starting construction/development.

First of all, urban land in Serbia is still exclusively state-owned and therefore, the existing system of use of urban land does not allow the land market and the transfer of the ownership in

land. On the other hand, the economic theory, and the business practice of developed countries both indicate that without true market allocation for a particular resource, there are no possibilities for its economically efficient use.

The existing model of urban land does not represent a good base for persuading investors to invest in Serbia. It is natural that the investment decision does not depend only on the commercial aspect of the activity in question, but also on the possibilities for stable and predictable use of land on which the intended structure is to be built. If the use of land is uncertain or unpredictable, then surely the interest of potential investors grows dimmer.

There are several sources of uncertainty in the existing model of using urban land. First of all, there is the uncertainty about the duration of use of land. Namely, even when the land is leased out for an indefinite period of time or when it is leased for a definite time, there is no strong guarantee that this will be respected by the authorities and that the user will be able to exploit the land in a manner that he initially planned. This is because the state can, and has done before, change the conditions of use of land through changes in the laws and local ordinances, and significantly influence the elements of agreements concerning land. It is possible that regulation plans and with them the intended type of uses of individual plots change, which would then be grounds for the termination of the right to use for an indefinite period of time, or even that for a definite period of time. Simply put, the state as the lessor just cannot offer the same amount of certainty as a private lessor because the state can change the conditions of use by unilateral actions, the way she sees fit.

Another point is that there is uncertainty in the possible privatisation of urban land, and especially in the method of privatisation of the parcel of urban land that an investor is using or wants to use. Of course, privatisation of urban land is possible, even probable in all transition or post-transition countries, therefore making the potential investors wonder about the probability and the possible direction of such privatisation. It is clear why the possibility of privatisation bothers investors: it is easily conceivable that their status might deteriorate or that they might be burdened by increased costs in such an event. This is because the following facts: 1) considering that until the parliament has reached the corresponding legislation the method of privatisation remains unknown, the existing lessee or user of state-owned land cannot know what specific measures will be adopted and whether or not he will remain the user after the privatisation had taken effect; 2) even if he was to remain the user, it is possible that he might be forced to pay a large sum for the purchase of land, which, together with the previously paid charges (such as the urban land development fee) might be a princely sum, even more than the piece of land in question is worth and more than the investor was prepared to pay initially.

Thirdly, there is uncertainty regarding the amount of the land use fee. Again, this is not a private legal matter, a contractual document entered into by a private owner and a lessee, where the method of indexation or change of lease amount would be known and agreed upon up front; this is a contract with the state which she can change, even through amendments in the legislation, in such a way as to replace the correction mechanism whenever she feels like it. It is clear then that long-term effects of the change of the mechanism for the correction of lease may be quite extensive.

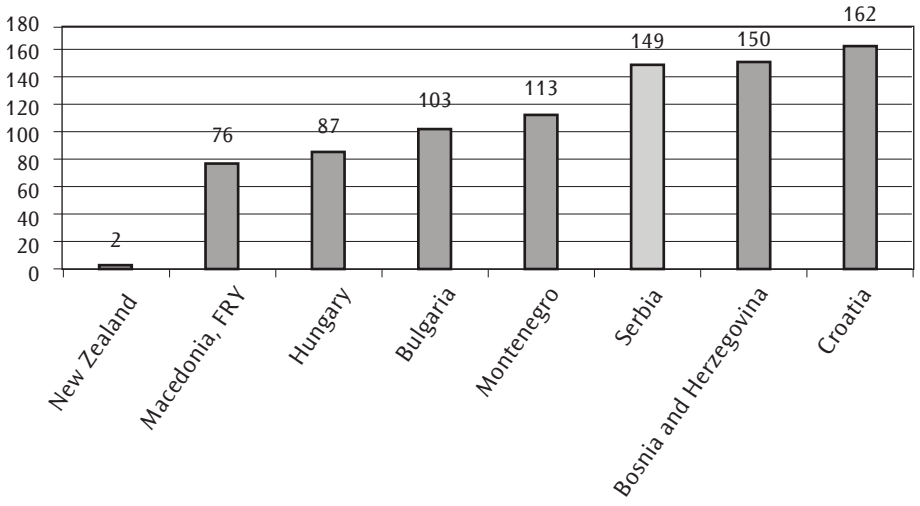
Fourth, related to the previous issues, it is very hard, almost impossible, for the investor to appraise the value of any given parcel of land. The main reason for that is, apart from the aforementioned uncertainties, the non-existence of the legal market of urban land and the non-existence of full ownership over urban land. The legal market of urban land does not exist because it is owned by the state and is only given to users to be used, i.e. the users may not sell it without the structures that lie on it. Transfer of land is possible only together with the structure upon it, but then it is not possible to separate the price paid for the structure from the price paid for the land. State ownership of urban land makes the user of urban land possess only a portion of overall property rights, i.e. the user is entitled to use the land in accordance with the law. Even aside from the fact that a certain piece of urban land is in state ownership, it still has, or may have a certain economic value for the user, because it enables, or may enable, an economic activity in accordance with the prescribed land use. The uncertainty relating to the value of land definitely deters potential investors from investing, because it is difficult to opt for an investment when the investor himself is unable to comprehend what the gained property is actually worth in the market.

All these uncertainties surely decrease the readiness of potential investors to invest in Serbia. This applies to both real property investors, i.e. those who practice construction/development and sale of commercial and residential space, and to the investors who would like to invest into economic companies. That this is not only theoretical reasoning is confirmed by information on how foreign investors view the land regime in Serbia and its consequences: dissatisfaction with the fact the land is in state ownership and with the method of its use is widespread and especially aggravated with uncertainty regarding future events.

However, even if we assume that land privatisation program shall be implemented in the near future, there are many other land-related obstacles faced by the potential investor. Doing Business reports that, in order to construct a standardized warehouse, there are 20 separate procedures, which take 204 days and cost more than 33 GDPs per capita.

Serbia is ranked 149th out of 178 countries assessed in this report.

Figure 2 Dealing with Licences: Global Ranking



The following table shows the comparison between Serbia and neighbouring countries in three subcomponents – number of procedures, time and cost for dealing with the licenses relevant for the development of the plot of urban land.

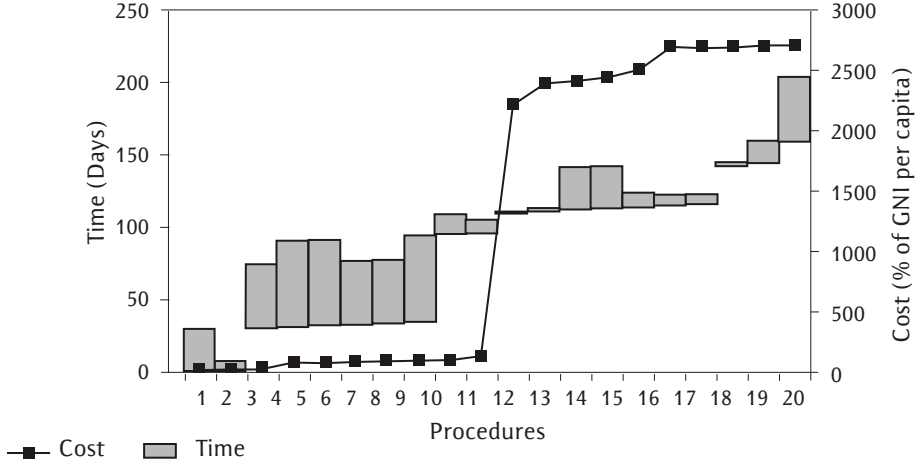
Table 3 Dealing with Licences: a Regional View

Country	Number of Procedures	Time (days)	Cost (% of GDP per capita)
Bosnia and Herzegovina	16	467	790
Bulgaria	22	131	500
Croatia	22	255	722
Hungary	31	211	10
Macedonia, FRY	19	192	110
Montenegro	19	185	600
Serbia	**20**	**204**	**2713**

It can be seen that in terms of number of procedures and time needed to obtain all the licenses and permissions, Serbia does not lag significantly behind the neighbouring countries. However, in terms of cost, Serbia is more than three times more expensive than the next most expensive neighbouring country.

The following graph shows the time and financial cost distribution:

Figure 3 Building a Warehouse in Serbia



The procedure 11, which is by far the most costly is "Paying Land Development Fee". It is clear that time that some procedures require is very long, such as 60 days to obtain a main construction project clearance from the traffic authority (procedure 8 in the Chart).

Foreign Investors Council also stresses the importance of land issues for FDI growth. Namely, in their most recent White Book (2007), this association of foreign investors recommends the following activities:

- Restitution of urban land - develop process to ensure transparency;
- Privatization of urban land not subject to restitution;

- Creating industrial/technology parks (National Investment Plan);
- Increased application of Article 86 of LOUPC (Law on Urban Planning and construction) in terminating rights of use for state-owned urban lands;
- Adoption of the Law on Property of Local Self-Governments;
- Improve links between public offices, availability of data and training.

These shortcomings are also recognized in the government FDI Strategy. The Strategy recommends that the Parliament should adopt a new Law on Planning and Construction, which should simplify and accelerate the whole construction/development process, especially related to leasing the land and granting construction permits. The new Law shall have to be more precise and clear and to prevent municipal officials from arbitrary decision-making. Also, the regulations should be clear regarding criteria for determining the level of the lease fee and land development fee. Further, the goal of the legislation should be that the procedure for granting construction permit upon the receipt of all the relevant document should take no longer than 15 days.

The Government Strategy also recognizes the need to privatize urban land. The Strategy proposes that both physical and legal entities should be allowed to buy the land from the state, which would use the funds to compensate former owners.

Judiciary and property issues

Serbia ranks poorly with regards to contract enforcement and other, more or less court-related procedures (closing a business, registering property). On all these issues Serbia is ranked below 100th place in the world.

Important and positive steps have been taken in these areas, primarily by taking the jurisdiction for bankruptcy process and for property registration out of the courts. However, contract enforcement is, and has to be, done in courts.

Compared to the regional economies, contract enforcement in Serbia lasts the longest and takes twice the time of that in Hungary.

Table 4 Contract Enforcement: a Regional View

Country	Number of Procedures	Duration (days)	Cost (% of claim)
Bosnia and Herzegovina	38	595	38.4
Bulgaria	40	564	22.2
Croatia	38	561	13.8
Hungary	33	335	13
Macedonia, FRY	39	385	33.1
Montenegro	49	545	25.7
Serbia	**36**	**635**	**28.4**

There was no progress on this issue in the past three years.

Table 5 Progress in Contract Enforcement

Enforcing Contracts	Doing Business 2006	Doing Business 2007	Doing Business 2008
Rank		99	101
Procedures (number)	36	36	36
Duration (days)	635	635	635
Cost (% of claim)	28.4	28.4	28.4

Serbian FDI Strategy recognizes the importance of court efficiency for the inflow of FDI's. The separate Annex of the Strategy deals only with the Court efficiency issues. The goal that the Strategy sets it to create a judiciary system which could, with its expertise and efficiency, respond to the needs of modern business, with speed and accuracy as the most important goals.

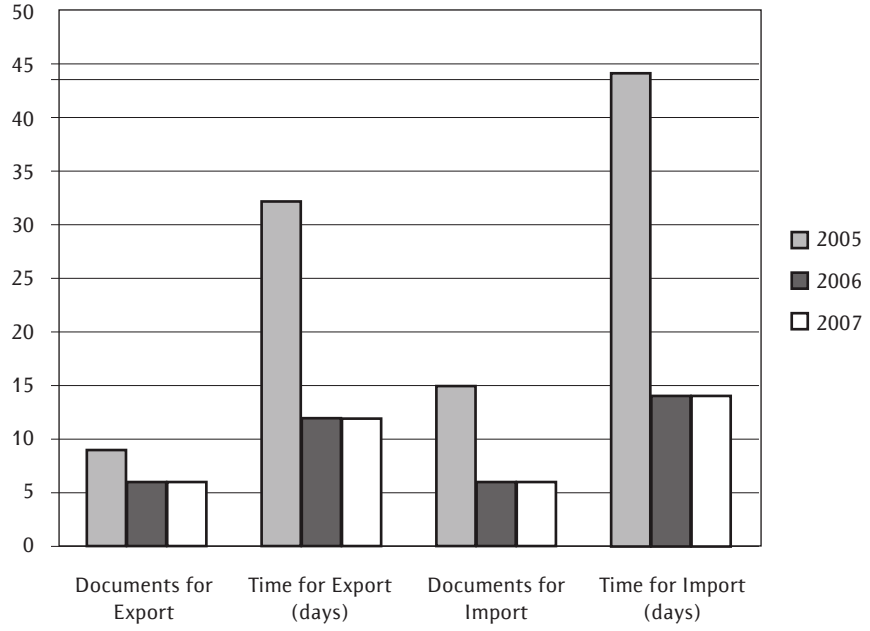
Paying Taxes and Trading Across Border

Paying taxes and trading across border are probably activities where the company gets into the most frequent contacts with the state administration. Although both of these activities are recurring and not specifically linked to either Greenfield or even foreign investment in general,

companies value efficient and not too cumbersome administration of imports, exports and paying taxes. Needless to mention, they also prefer lower taxes and customs duties.

Serbia is ranked relatively highly (58th position) on the Trading Across Border indicator. This is also the area where paperwork and time to import and export has been significantly reduced in the past three years.

Figure 4 Trading Across Borders



On the other side, Paying Taxes indicator is much more problematic, since Serbia is ranked 121st in the world. Additionally, there was no progress in the past three years. In a specific case, documented by the Doing Business Report, there are 66 tax payments per year (compared with the world leader Sweden, where only two payments per year are made), it takes 279 days to pay those taxes and the average business tax rate is 35.8%.

Compared to other countries in the region, the number of payments is very high, but the overall tax rate is relatively low, while time needed to pay the taxes is in the middle.

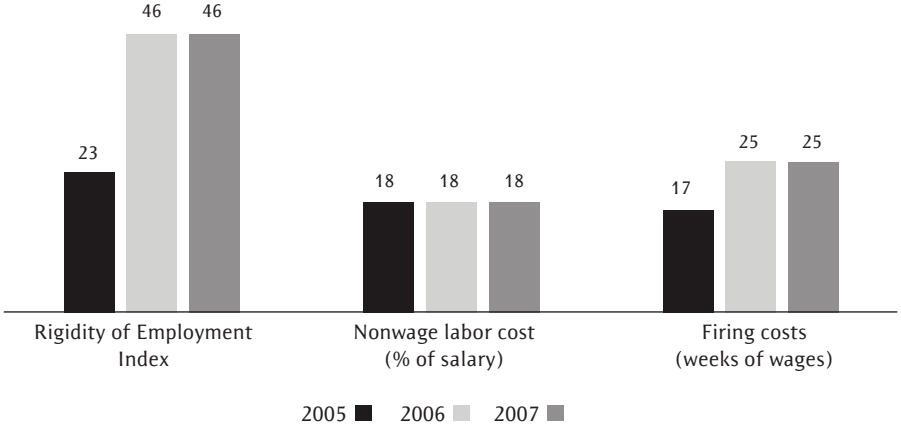
Table 6 Paying Taxes: a Regional View

Country	Payment (number)	Time (hours)	Total tax rate (% of profits)
Bosnia and Herzegovina	51	368	44.1
Bulgaria	17	616	36.7
Croatia	28	196	32.5
Hungary	24	340	55.1
Macedonia, FYR	52	96	49.8
Montenegro	88	372	31.6
Serbia	**66**	**279**	**35.8**

Labor Market Regulations

Doing Business Report also ranks countries according to the labor market regulations (employing workers indicator). Serbia ranks 110th, which is very low and also, there was some deterioration in 2006, after the adoption of the new Labor Law.

Figure 5 Labor Market Regulation: Change in Time



Compared to its neighbors, Serbia is ranked in the middle in terms of the rigidity of employment, but is better in terms of the non wage labor costs and firing costs than most of its neighbors.

Table 7 Flexibility of the Labor Market: a Regional View

Country	Rigidity of Employment Index	Non wage labor cost (% of salaries)	Firing costs (weeks of wages)
Bosnia and Herzegovina	46	15	31
Bulgaria	29	23	9
Croatia	50	17	39
Hungary	30	34	35
Macedonia, FYR	50	33	26
Montenegro	38	18	39
Serbia	**46**	**18**	**25**

4. Conclusion

There is no doubt that business environment is decisive for investors to make their decisions about FDIs in general and Greenfield investments in particular. Many components of that environment are endogenous, i.e. recipient's county government can do something about it. Although Serbia substantially improved its business environment in the recent years, there is a huge room for improvement. A single area that needs to be substantially improved is the one related to "dealing with licenses", i.e. the costs of developing a plot of land. Since this specific cost/obstacle is relevant for Greenfield investments only, this is perhaps a part of the answer to the question why other forms of FDIs have been more intensive. As it was demonstrated this particular obstacle proved to be a combination of poor legislation and its unproductive enforcement by local authorities who are in charge of its implementation. Obviously there is a room for improvements on both levels, particularly as a competition for attracting FDIs can be developed among the local authorities in Serbia in, for example, creating industrial parks.

Improvement regarding paying taxes means first and foremost improved tax legislation, particularly the part regarding the process of taxation and the tax administration operations. Nonetheless, some other areas should not be neglected, like enforcing the contracts, registering property employing workers, closing a business, since they consist major costs of doing business in Serbia.

Chapter V
Conclusions

Greenfield investments are seen as a major (42%) mode of FDI entry in Central and Eastern Europe. This is partly because major privatizations have already been performed, and also because efficiency-seeking investors are estimating a good future for this region. During the past six years, the transition economies have become a record FDI recipient and the second most competitive region worldwide (second only to Asia among emerging markets). A new trend recorded in these countries is that privatization-led FDIs have declined and Greenfield investments have grown in both the East and Central European countries. Hungary, Poland, Romania and the Czech Republic have become important Greenfield destinations. Within South Eastern European countries, a clear distinction emerged between four countries (Bulgaria, Romania, Croatia and Serbia), on the one side, and the other four SEE countries (BIH, Albania, Macedonia and Montenegro), who attracted several times less abundant FDI flows.

As for Serbia, owing to a well-chosen privatization method, the country has been evidencing growing FDI inflows since 2000. The surge in 2006, however, is not likely to be repeated in the near future, since it coincided with peak FDIs in the whole region, and came primarily as a consequence of the privatization of the mobile telecommunications company *Mobtel*, purchased by *Telenor* for almost EUR 1,513 million (slightly less than USD 1.9bn), followed by *Philip Morris*, *mobilkom austria group* and many others. A decline in 2007 was followed by political turbulences in 2008 and many investment opportunities are still waiting to be realized.

Serbia remains a country with the smallest share of tradables, which should be a serious warning to economic policy makers when analyzing the results of recent FDI flows. Empirical studies have shown that growth tends to be more sustainable in countries with strongly performing tradables sectors. Ireland is an example in Europe of rapid and sustainable catch-up with large capital inflows, in particular FDI, that boosted export production. Portugal, on the other hand, is an example of stalled catch-up, with large inflows of capital into consumption and investments in nontradables, including real estate. The widening current account deficit became unsustainable as competitiveness was lost following real exchange rate appreciation, and the boom turned bust as growth slowed down. While all FDIs should by no means be welcomed, economic policy should deeply investigate success stories in attracting FDIs from the tradables sector and try to imitate their success.

A question remains unsolved in economics as to whether investments lead growth or arise as consequences of economic growth. But when trying to resolve the difference in the influence of the Greenfield and the brownfield investments on economic growth, the results are that both Greenfield and M&A FDIs lead domestic investment but are led by GDP growth. Therefore, economic growth, as the most important indicator of domestic rates of return, serves as an effective "pull" factor for foreign investment; and in turn, FDI helps increase domestic investment in the future. In addition, a stronger correlation has been found between Greenfield investments and economic growth (0.42) as compared to total investments (0.26) and economic growth. The analysis on the impact of FDIs on economic growth for thirteen countries of Central and Eastern Europe over the whole transition period shows that FDI indeed had a significant positive impact on the rate of economic growth, and that countries that were less successful in attracting FDI generated less growth than they might have. In other words, the outcome of the empirical investigation assigns FDI an important role as a growth determinant as well.

The assertion that FDIs would automatically lead to a strong increase in production and employment can often be misleading, since it is not the level of FDI that matters, but the kind of FDI. Only Greenfield and horizontal investment turn out to create new employment in the short run, while other FDI modes operate as a buffer to reductions in overall employment (but significant cross-country differences are recorded as well).

Regardless of the type of FDI the long term effect from the FDI induced productivity gains on labor demand are positive. In addition to these potential effects, which in principle apply to all kinds of private capital inflows, the gains to host countries from FDI can take several other forms. For example, FDI also brings significant transfer of technology that cannot be achieved through financial investments or trade in goods and services. FDI can also promote competition in the domestic input market. Recipients of FDI often gain employee training in the course of operating the new businesses, which contributes to human capital development in the host country. Profits generated by FDI contribute to corporate tax revenues in the host country.

Depending on the type of FDIs, whether market or efficiency seeking, FDIs can become successful exporters. In the case of Hungary and Ireland, eight out of the ten greatest exporters are Greenfield investments, with export share in sales of over 80%. Still, a brownfield investor, *US Steel*, represents the Serbian greatest exporter so far. Other investors, such as Greenfield *Ball Packaging*, stand for an extremely successful, but unfortunately almost the only case of, efficiency-seeking FDI in Serbia. Most FDIs in Serbia are market-seeking and belong to the non-tradable sector. Still, most of them are extremely important for improving the Serbian

business environment: from telecommunications (*Telenor*, *Vip*) to a whole set of FDIs in banking, insurance, and retail. Not only do they raise competitiveness, but they also create an environment which can then become more attractive to efficiency-seeking FDIs. These types of FDIs are utterly important for the economic stability of the country since they help in preventing balance of payments from overheating (deteriorating), which has recently become a serious problem of the Serbian economy.

Most studies examining the "net assessments" of the impact of FDI in some 30 countries over the past 15 years have found "a clearly positive impact on the economic welfare of the host". Additionally, macroeconomic country studies generally have found a positive impact of FDIs. It remains the challenge for a host country to make its environment competitive enough and to attract the best investors and, thus, maximally increase economic growth, employment and export opportunities of the country.

There is no doubt that spillover effects of the FDIs, particularly of the Greenfield FDIs, are substantial and important for the economic growth and welfare of the recipient country's society. It was demonstrated that these effects are versatile and that they have an impact on both producers and consumers. At the end of the day there is also a beneficial impact to consumers. Spillover effects are particularly important in some industries, such as modern telecommunications and banking, as they have become a kind of a prerequisite for modern economic growth, a growth of the new economy.

Substantial spillover effects of the Greenfield FDIs in Serbia have been recorded in the area of increasing competition (competitive pressure, i.e. rivalry) rendering a higher quality of products, introducing new services by imitation, both downstream and upstream vertical links to domestic suppliers and purchasers, and investments in human capital.

There are two very important findings regarding the recipient country. The first one is that it has proven impossible to measure precisely spillover effects and to disclose then in monetary terms, as methodological obstacles are too high. Taking this into account, it should be recommended that a country not subsidize FDIs. Some people find rationale for such subsidies in the very fact that investors are not capturing the spillover effects they are producing, so they should be compensated for that. However, without precise measurement such compensation is not feasible, let alone the damage that it can do as private interests capture the state. These dangers are rather relevant for thinking about public policies regarding Greenfield FDIs in Serbia.

The second finding is that the scale and scope of spillover effects heavily depend on the recipient country, predominantly local firms and their absorptive capacity. It is of crucial impor-

tance that the gap between foreign direct investors and local firms is not too big; otherwise, the spillover effects will be negligible. It is the labor force of the country which is crucial for the absorptive capacity. The more flexible and better educated the labor market, the better labor force propensity toward greater absorptive capacity.

It was demonstrated that labor in Serbia is not a cheap resource. It is the flexibility of the labor force and its ability to learn fast that attracts FDI to Serbia. The labor force in Serbia has its own quality and dynamism, and it is highly motivated and adaptable – it can adapt to new business principles and culture. Locally trained engineers are considered as the best offspring of the Serbian education system. Furthermore, the Serbian labor force is rather loyal to the employer and employee turnover is much smaller than in some EE countries.

The business environment is decisive for investors to make their decisions about FDIs in general and Greenfield investment in particular. Many components of that environment are endogenous, i.e., the recipient country's government can do something about it. Although Serbia has substantially improved its business environment in the recent years, there is huge room for improvement. A single area that needs to be significantly improved is the one related to "dealing with licenses", i.e., the costs of developing a plot of land. Since this specific cost/obstacle is relevant for Greenfield investments only, this is perhaps a part of the answer to the question about why other forms of FDIs have been more intensive. As it was demonstrated, this particular obstacle proved to be a combination of poor legislation and its unproductive enforcement by local authorities who are in charge of its implementation. Obviously there is room for improvement on both levels, particularly as competition for attracting FDIs can be developed among the local authorities in Serbia in, for example, creating industrial parks.

Improvement regarding paying taxes means first and foremost improved tax legislation and administration, particularly regarding the process of taxation and the tax administration operations. Nonetheless, other areas should not be neglected, such as enforcing contracts and registering property (both heavily dependent on judiciary reform), as well as employing workers and closing a business, since all of these activities comprise major costs of doing business in Serbia.

Glossary

Acquisition

A corporate action in which a company buys most, if not all, of the target company's ownership stakes in order to assume control of the target firm. Acquisitions are often made as part of a company's growth strategy, whereby it is more beneficial to take over an existing firm's operations and niche compared to expanding on its own. Acquisitions are often paid in cash, the acquiring company's stock or a combination of both. Acquisitions can be either friendly or hostile. Friendly acquisitions occur when the target firm expresses its agreement to be acquired, whereas hostile acquisitions don't have the same agreement from the target firm and the acquiring firm needs to actively purchase large stakes of the target company in order to have a majority stake

In either case, the acquiring company often offers a premium on the market price of the target company's shares in order to entice shareholders to sell. For example, News Corp.'s bid to acquire Dow Jones was equal to a 65% premium over the stock's market price

Reference: OECD Glossary of Foreign Direct Investment Terms and Definitions

Agglomeration

The phenomenon of economic activity congregating in or close to a single location, rather than being spread out uniformly over space.

Reference: Deardorff's Glossary of International Economics

Agglomeration economy

Any benefit that accrues to economic agents as a result of having large numbers of other agents geographically close to them, thus tending to lead to agglomeration.

Reference: Deardorff's Glossary of International Economics

Brownfield investment When a company or government entity purchases or leases existing production facilities to launch a new production activity. This is one strategy used in foreign-direct investment. The alternative to this is a Greenfield investment, where a new plant is constructed.

Reference: INvestopedia

Definition of FDI / Foreign Direct Investment FDI stands for Foreign Direct Investment, a component of a country's national financial accounts. Foreign direct investment is investment of foreign assets into domestic structures, equipment, and organizations. It does not include foreign investment into the stock markets. Foreign direct investment is thought to be more useful to a country than investments in the equity of its companies because equity investments are potentially "hot money" which can leave at the first sign of trouble, whereas FDI is durable and generally useful whether things go well or badly. Reference: (Econterms)

This category of international investment is made by a resident entity in one economy (direct investor) with the objective of establishing/obtaining a lasting interest in an enterprise resident in an economy other than that of the investor (direct investment enterprise). "Lasting interest" implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor on the management of the direct investment enterprise. Direct investment involves both the initial transaction between the two entities and all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated.

Reference: 5th edition of Balance of Payment Manual (BPM5) (International Monetary Fund); Detailed Benchmark Definition of the Foreign Direct Investment (Organization for Economic Cooperation and Development); and Glossary of Foreign Direct Investment Terms (Survey of Implementation of Methodological Standards for Direct Investment (SIMSDI)

Externality or spillover An *externality or spillover* exists whenever the production or consumption decisions of one individual unintentionally impact on the production or consumption decisions of others in some way other than through the market.

Foreign Direct Investment Enterprise

A foreign direct investment enterprise is an enterprise resident in one economy and in which an investor resident in another economy owns, either directly or indirectly, 10% or more of its voting power if it is incorporated or the equivalent for an unincorporated enterprise.

The numerical threshold of ownership of 10% of the voting power determines the existence of a direct investment relationship between the direct investor and the direct investment enterprise. An ownership of at least 10% of the voting power of the enterprise is regarded as the necessary evidence that the investor has sufficient influence to have an effective voice in its management.

Foreign Direct Investor

A foreign direct investor is an entity (an institutional unit) resident in one economy that has acquired, either directly or indirectly, at least 10% of the voting power of a corporation (enterprise), or equivalent for an unincorporated enterprise, resident in another economy. A direct investor could be classified to any sector of the economy and could be any of the following:

(i) an individual;
(ii) a group of related individuals;
(iii) an incorporated or unincorporated enterprise;
(iv) a public or private enterprise;
(v) a group of related enterprises;
(vi) a government body;
(vii) an estate, trust or other societal organization;
(viii) any combination of the above.

In the case where two enterprises each own 10% or more of each other's voting power, each is a direct investor in the other.

A direct investor has a direct investment enterprise operating in a country other than the economy of residence of the foreign direct investor.

Foreign Equity Capital

Foreign equity capital comprises: (i) equity in branches; (ii) all shares in subsidiaries and associates (except nonparticipating, preferred shares that are treated as debt securities and included under direct investment, other capital); and (iii) other capital contributions of foreign investors in a direct investment enterprise.

Reference: 5th edition of Balance of Payment Manual (BPM5), International Monetary Fund;

Greenfield investment

A form of foreign direct investment where a parent company starts a new venture in a foreign country by constructing new operational facilities from the ground up. In addition to building new facilities, most parent companies also create new long-term jobs in the foreign country by hiring new employees.

This is opposite to a brownfield investment. Greenfield investments occur when multinational corporations enter into developing countries to build new factories and/or stores.

Developing countries often offer prospective companies tax-breaks, subsidies and other types of incentives to set up Greenfield investments. Governments often see that losing corporate tax revenue is a small price to pay if jobs are created and knowledge and technology is gained to boost the country's human capital.

Reference: INvestopedia

Gross domestic product (GDP)

A measure of the value of all the goods and services newly produced in an economy during a specified period of time.

Horizontal and vertical FDIs

The most evident form of FDI is Horizontal FDI, which involves investments in the same industry abroad as the firm does at home. The second group, Vertical FDI can be subdivided into two forms.

Backward vertical FDI is the mode of vertical FDI where an industry abroad provides an input for a firm's domestic production process. When an industry abroad sells the output of a firm's domestic production process, we speak about Forward vertical FDI.

Internal Knowledge Spillover

Internal knowledge spillover is positive learning or knowledge externalities between programs or plants within a production organization.

Reference: (Econterms)

Liabilities, Direct Investment

Direct investment liabilities can be ascribed to the following three categories:

(i) investment of non-resident direct investor in resident direct investment enterprises

(ii) reverse investment of non-resident direct investment enterprises in resident direct investors

(iii) investment of non-resident fellow enterprises in resident fellow enterprises.

Reference: OECD Glossary of Foreign Direct Investment Terms and Definitions

Management Risk

Management risk refers to the chance that company managers will put their own interests ahead of the interest of the company and shareholders. Management risk also applies to investment managers, whose decisions and actions may divert from investors' wishes or reduce the value of an investment portfolio. The risks are associated with ineffective, destructive or underperforming management, which hurts shareholders and the company or fund being managed. This term refers to the risk of the situation in which the company and shareholders would have been better off without the choices made by management.

Reference: INvestopedia

Merger

A merger occurs when two (or more) companies agree to merge into a new single company rather than remain separated for creating business synergies.

Other foreign direct investment capital

Other foreign direct investment capital covers the borrowing or lending of funds between foreign direct investors and subsidiaries, branches, and associates – including debt securities, suppliers' credit, and nonparticipating, preferred shares (which are treated as debt securities).

Reference: 5th edition of Balance of Payment Manual (BPM5), International Monetary Fund; 1993 System of National Accounts Detailed Benchmark Definition of the Foreign Direct Investment, Organization for Economic Cooperation and Development); and Glossary of Foreign Direct Investment Terms, Survey of Implementation of Methodological Standards for Direct Investment (SIMSDI) 1993 System of National Accounts

Outward Direct Investment

Outward direct investment is investment by a resident direct investor in a non-resident direct investment enterprise; the direction of the influence by the direct investor is "*outward*" for the reporting economy. Also referred to as direct investment abroad.

Reference: OECD Glossary of Foreign Direct Investment Terms and Definitions

Political Risk

Political risk is the risk that an investment's returns could suffer as a result of political changes or instability in a country. Instability affecting investment returns could stem from a change in government, legislative bodies, other foreign policy makers, or military control.

Political risk is also known as "geopolitical risk", and becomes more of a factor as the time horizon of an investment gets longer. Political risks are notoriously hard to quantify because there are limited sample sizes or case studies when discussing an individual nation. Some political risks can be insured against through international agencies or other government bodies.

The outcome of a political risk could drag down investment returns or even go so far as to remove the ability to withdraw capital from an investment

Reinvested earnings and undistributed branch profits of foreign direct investment enterprises

These are comprised of foreign direct investors' shares, in proportion to equity held, of earnings that foreign subsidiaries and associated enterprises do not distribute as dividends (reinvested earnings), and earnings that branches and other unincorporated enterprises do not remit to foreign direct investors (undistributed branch profits).

Reference: 5th edition of Balance of Payment Manual (BPM5), International Monetary Fund; 1993 System of National Accounts

Resident of an economy

Resident of an economy is an entity that has a center of economic interest in the economic territory of a country, usually indicated by a one-year stay in that economy. The one-year period is suggested only as a guideline and not as an inflexible rule

References: 5th edition of Balance of Payment Manual (BPM5) (International Monetary Fund); Detailed Benchmark Definition of the Foreign Direct Investment (Organization for Economic Cooperation and Development); and Glossary of Foreign Direct Investment Terms (Survey of Implementation of Methodological Standards for Direct Investment (SIMSDI) 1993 System of National Accounts

Transfer Pricing

The transaction value for a good or service between related enterprises may not always reflect market values. *Transfer pricing* refers to the distortion between transaction values and market values. It can motivated by income distribution or equity injections or withdrawals. Where the distortion is significant and data is available to do so, it is recommended that adjustments be made to remove the impact of transfer pricing.

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